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OCTOBER TERM, 1971

No. 71-319

EDWARD C. JOHNSON 2d, EDWARD C. JOHNSON 3d, FIDELITY MANAGEMENT & RESEARCH COMPANY and THE CROSBY CORPORATION

Petitioners

v.

ROSE MOSES, FIDELITY FUND, INC., C. RODGERS BURGIN, GEORGE R. HARDING and GILBERT H. HOOD, JR.

Respondents

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

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September, 1971

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

The petitioners, Edward C. Johnson 2d, Edward C. Johnson 3d, Fidelity Management & Research Company and The Crosby Corporation respectfully pray that a writ of certiorari issue to review the judgment of the Court of Appeals for the First Circuit entered June 4, 1971, in this proceeding.[1]

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[1] The Court of Appeals affirmed the dismissal of the case as to the unaffiliated director defendants Burgin, Harding, Hood and Ronald Jones. (A.60; B.29, 31) Except for Jones, who is deceased, they are technically respondents herein under Rule 21(4).

OPINIONS BELOW

The opinion of the Court of Appeals is not yet officially reported, but appears in Appendix B. The findings of fact and opinion incorporating conclusions of law of the District Court for the District of Massachusetts are reported at 316 F. Supp. 31 and appear in Appendix A.

JURISDICTION

The judgment of the Court of Appeals was entered June 4, 1971. (B.31) The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

QUESTIONS PRESENTED

1. Whether the Securities Exchange Act of 1934 and the Sherman Act make unlawful a scheme which certain stock exchange officials "chose to permit", under which one particular class of customers would receive preferential commission rates on stock exchange transactions, notwithstanding exchange minimum commission schedules and antirebate rules applicable to all customers.

2. Whether the Court of Appeals erred in holding, contrary to standards laid down by the Second Circuit, that a mutual fund's adviser and certain of its directors are "guilty" of "gross misconduct" under Section 36 of the Investment Company Act of 1940 because of a failure — "however motivated" — to report to the unaffiliated fund directors a "matter . . . that could be thought to be of possible significance", notwithstanding their reasonable belief, with the advice of counsel, that the matter would have been illegal.

STATUTORY AND REGULATORY PROVISIONS INVOLVED

The case involves Section 36 of the Investment Company Act of 1940, 15 U.S.C. § 80a-35, Sections 5, 6 and 19 of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78e, 78f and 78s, Section 1 of the Sherman Act, 15 U.S.C. § 1, and SEC rules 6a-2, 6a-3 and 17a-8 under the Securities Exchange Act, which appear in Appendix C; and minimum commission, antirebate, and give-up rules of certain registered securities exchanges, which appear in Appendix D.

STATEMENT OF THE CASE

This derivative action was brought in December 1967 by Rose Moses, a shareholder of Fidelity Fund, Inc. (the "Fund"), an open-end investment company of the type generally called a "mutual fund." (F.1-2, A.3)[2] Like virtually all mutual funds, the Fund employed an investment adviser, Fidelity Management & Research Company (FMR), with which it had certain common directors and officers, to furnish investment advice to it regarding its portfolio securities and to manage its day-to-day affairs. (F.3, A.3-4) It employed The Crosby Corporation ("Crosby"), a wholly-owned subsidiary of FMR, to serve as the exclusive wholesale distributor or "principal underwriter" of the Fund's shares in the continuous public offering which the Fund made. In this capacity, Crosby sold shares of the Fund (and of the other funds in the Fidelity group) to independent broker-dealers who then resold them to investors; this was Crosby's sole function. (F.4, A.4)

[2] Reference abbreviations are used herein as follows: "F." refers to the findings of the District Court; "R." to the record appendix in the Court of Appeals; "Ex." to the separately bound exhibits; and "A.", "B.", "C.", "D." and "E." to the Appendices, thus designated, to this petition.

The defendants in the action, in addition to the Fund, were FMR; Crosby; E. C. Johnson 2d, president, director and principal voting stockholder of FMR and also president and a director of the Fund; E. C. Johnson 3d, a director and voting stockholder of FMR and since April 1968 a director of the Fund; and the other directors of the Fund, who were not affiliated with FMR or Crosby. (F.3-7, A.3-4; B.1-2)

The Complaint charged a number of violations of the Investment Company Act and other breaches of duty on the part of the defendants, relating primarily to brokerage practices concerning transactions in the portfolio securities of the Fund. The District Court after a trial lasting over a month found for the defendants on all charges. Many of plaintiff's points were not pressed on appeal; on the rest the Court of Appeals affirmed the District Court's findings of no liability — except as to one matter.

That matter had to do with the petitioners' failure to employ, at a time earlier than 1968, a scheme for obtaining rebates of brokerage commissions to the Fund — a scheme which the Court of Appeals called "NASD Recapture." No mutual fund manager had, prior to 1968, engaged in NASD Recapture; and the Fidelity group of funds were the first funds of any substantial size to "recapture" in this way — although this "recapture" was effected with full realization of the risks of the illegality of the scheme. (R.1591, 1037, 1045, 1057, 3425; see F.82, A.28) Nonetheless, the Court of Appeals found the two Johnsons, FMR and Crosby "guilty" of "gross misconduct" arising out of the failure of the Fund to "recapture" earlier.

A. So-Called "NASD Recapture" — Background

Most of the Fund's portfolio securities transactions were executed on the New York Stock Exchange ("NYSE") and

the principal regional exchanges [3] — whose trading volume is primarily in stocks also listed on the NYSE. At all pertinent times, the constitutions and rules of each stock exchange, filed with the Securities and Exchange Commission ("SEC") under the Securities Exchange Act of 1934 ("Exchange Act"), provided for a system of fixed minimum commissions required to be charged to customers by all brokers executing securities transactions.[4] These fixed minimum commissions became in practice the commissions in fact charged.[5] The minimum commissions prescribed were based on the commission for a 100-share "round lot" without any quantity discount. (R.3741) The commission on a 100,000 share transaction was thus exactly 1,000 times as large as that on a 100 share transaction. On many large transactions, such as those engaged in by sizeable mutual funds, the commission scale thus ordained was such that brokers would be perfectly willing to execute the transactions even if they did not retain, or were to "give up", a substantial portion of their commission to other brokers.

As a corollary to its minimum commission rules, every exchange also had broadly written and strongly stated rules prohibiting any rebating of commissions to customers.[6]

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[3] Regional exchanges utilized by the Fund were the Midwest Stock Exchange (Midwest Exchange), the Detroit Stock Exchange (Detroit Exchange), the Boston Stock Exchange (Boston Exchange), the Pacific Coast Stock Exchange (Pacific Exchange) and the Philadelphia-Baltimore-Washington Stock Exchange (PBW Exchange).

[4] *E.g.*: "commissions shall be at rates not less than the rates in this Article prescribed"; D.1, 2, 7, 18-19, 20.

[5] SEC, PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH (1966) ("PPI"), Ex. 6, p. 157.

[6] F.38-39, A.13-14; D.1, 3, 7-8, 19, 20, 22. The prototype of all exchange antirebate rules (A.51) is that of the NYSE. (F.38, A.13-14) Its purpose has been stated by an NYSE vice president as follows: "if you have a minimum, it is a minimum that must be charged. If you permit people to give part of it back, it ceases to be a minimum." (R.4339)

These antirebate rules were all duly filed with the SEC under the Exchange Act. Typical was the Philadelphia-Baltimore-Washington (PBW) Exchange's rule:

> ". . . commissions . . . shall be absolutely net and free from any rebate, return, discount or allowance in any shape or manner, or by any method or arrangement, direct or indirect." PBW Const., art. XX, § 1, D.2-3.

Certain exchanges also had in effect and on file with the SEC rules permitting so-called "give-ups" from one broker to another. Under these rules, a broker could share his commission with another broker, either on his own motion or at the direction of his customer. The antirebate rules contained no exception in favor of the "give-up" rules, which, of course, indicated that the give-up rules were to be employed to divide commissions among members of the brokerage community, but not to give the money back to the customers.

On the NYSE, commissions could be shared only with other brokerage firms that were members of that Exchange, but in the case of some of the regional exchanges, the rules permitted give-ups to be directed to nonmembers of the exchange in question if the recipient was a member of the National Association of Securities Dealers, Inc. ("NASD").[7] Since there was no way in which the commissions could be rebated to the customer, that is, the mutual fund, a wide-spread practice of mutual funds was to direct the executing brokers on both the NYSE and the regional exchanges to give up a portion of their commis-

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[7] The Boston, Detroit and PBW Exchanges had such rules. (D.3-4, 19-20, 21-22) The Pacific Exchange had a rule which reached a similar result since it permitted give-ups to be directed to "approved non-members" (D.10-11) and NASD members could qualify as "approved non-members." (D.13)

sions to other brokers who had good records in the sale of shares of the fund to the public.[8]

The "NASD Recapture" scheme turned on the circumstance that the wholesale distributors of mutual funds (in the present case Crosby) were required by the Exchange Act to register as broker-dealers and in virtually all cases were members of the NASD. (R.3743) — Of course, these "distributors" were not stockbrokers in any conventional sense of the word; like Crosby, most had as their only business the wholesale distribution of fund shares to other broker-dealers. (F.58, A.21) — The scheme was for a mutual fund to place a trade on a regional exchange and then direct the executing broker to give up a portion of the brokerage commission *to the fund's distributor.* The fund's distributor or its investment adviser[9] would then give a rebate to the fund by giving it credit in the amount of the give-up against the advisory fee otherwise payable by the fund to the adviser. (F.44, 65, A.15, 23; B.11, 22-23)

On the face of it, this scheme is patently a rebate to the customer of the executing broker; the District Court so held (A.51) and the Court of Appeals did not disagree. (See B.24) This device of NASD Recapture took place on the PBW and Pacific Exchanges for a portion of 1968 in the face of their minimum commission and antirebate rules, without any amendment to or exception from those rules being adopted by the governing body of the exchange or filed with the SEC under the Exchange Act, and indeed simply on the basis of a private letter from an exchange

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[8] The industry in general and Fidelity Fund in particular followed this practice and described it in prospectuses and proxy material mailed to all shareholders and filed with the SEC. (F.92-93, A.31-33)

[9] The two functions are often combined in one corporation, although in FMR's case Crosby, an FMR subsidiary, served as distributor.

officer that the scheme would be tolerated. (F.71, 78-79, 84, A.24-25, 27, 29) The scheme could be used only by investment companies. (*Infra*, p. 18, n.16) The other regional exchanges which permitted give-ups to NASD members all indicated that they would not permit or tolerate NASD Recapture. Their constitutions and rules were similar in all material respects to those of the Pacific and PBW Exchanges. (F.39, 41, A.14-15)

B. The History of "NASD Recapture"

Since no mutual fund actually engaged in the scheme now called NASD Recapture until 1968, the earlier history of NASD Recapture is not the history of a practice but the history of an abstract notion or concept. The first people to entertain the concept were certain staff members of the SEC. (F.65, A.23) In June 1965 and September 1966 SEC staff members conducted two on-the-record interviews, ranging over a variety of subjects of industry-wide concern, with Fidelity Fund representatives (R.2110, 2167); these were similar to interviews held at the time with representatives of a number of other mutual funds. (R.2294) In the course of the first interview, an SEC staff member suggested that Crosby, could be designated by the Fund as a recipient of give-ups on the Detroit Exchange by reason of its status as an NASD member, and that these give-ups could then be rebated to the Fund by a credit against the advisory fee. (F.65, A.23) The SEC staff member even described the procedure as "a rebate of commissions." (*Id.*; R.2154) No one had attempted such a thing at the time. (See F.69, A.24) The SEC staff members never offered any enlightenment as to how the antirebate rules of the exchanges could lawfully be ignored or circumvented in obtaining the "rebate" to which they referred.

Immediately after the second interview, Loring, general counsel of FMR (R.707) and a partner in Gaston, Snow, Motley & Holt, met with those who had attended — Sullivan and Hamilton, officers of FMR and the Fund (R.4225), and Belash, another partner in the Gaston Snow firm (R.747), who were counsel for both the Fund and FMR. (R.715, 718) Loring reviewed transcripts of both interviews with Hamilton and Belash. (R.715) He discussed with Belash various legal problems raised by the suggestion of NASD Recapture and by a related suggestion made at the interviews.[10] Sullivan consulted with Belash and Loring (R.2298-99), who advised him that "it was their conclusion at that time that the antirebate rules would prohibit such recapture." (R.2299) Sullivan relied on counsel's advice. (R.2300) Loring also advised Johnson 2d that he had talked with Belash about the SEC staff suggestions and "that there was no way that we could do what had been suggested at this SEC hearing." (R.180; see also R.264, 543-44, 719, 744-45)

On December 2, 1966, the SEC issued a 346-page report entitled "Public Policy Implications of Investment Company Growth" ("PPI"). The report made one isolated reference to the notion of NASD Recapture:

> "Similar competitive factors have also operated against the use, for the benefit of the funds and their shareholders, of regional exchange rules permitting give-ups to any member of the NASD on transactions

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[10] This was that brokerage profits be recovered through membership on the Pacific Exchange. (R.2155, 2210-11) Four fund groups had done this through brokerage subsidiaries in 1965. (F.62, A.22) Rule changes later that year precluded any fund group from doing it again (see PACIFIC RULE IX, §§ 3, 5(a)(6), D.11-12) and in any event neither FMR nor Crosby was ever eligible for such membership because, unlike the four fund groups, they did not sell fund shares directly to the public through their own salesmen. (F.63, A.23) The SEC staff members showed no awareness of these membership requirements at either interview.

> executed on those exchanges. It would not be inconsistent with those rules [*i.e.*, the give-up rules] for dealer-distributed funds to direct give-ups to their adviser-underwriters, all of whom are NASD members, for the purpose of applying these give-ups to reduce the advisory fees payable by the funds."[11] PPI, Ex. 6, p. 173.

While the report stated that the rebates to mutual funds would not be inconsistent with the *give-up* rules, it did not undertake to explain how they could be squared with the *antirebate* rules — rules which a reader would find somewhat more in point. The recommendations of the report in the area of brokerage costs were that exchange rules should be amended to *preclude* customer-directed give-ups altogether (p. 186) — thereby cutting the ground from under NASD Recapture — and that quantity discount schedules should be introduced (p. 187). (See F.92, A.32)

Before the end of that month (December 1966) Johnson 2d and Sullivan reviewed PPI and among other things instructed Loring to make a thorough study of the "recapture suggestions" in PPI. (R.744-45) In doing so, Loring also examined the sections of the SEC Special Study of Security Markets relating to mutual fund brokerage. (R.748) He noted, in particular, portions of the Study which stated that antirebate rules "prohibit the reduction of commission charges to the funds and forbid the return of any part of the commission to them". (R.4858) This reinforced his conclusion that NASD Recapture was impossible because of the exchange antirebate rules. (R.749)

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[11] Loring sent a copy of the PPI report to the unaffiliated directors' counsel 10 days after its publication (R.740-42, 4855-56) and subsequently gave the directors the SEC's official 11-page summary of the report. (Ex. A-3 (tab: SEC Report to Congress); R.733-37) Neither Loring nor the SEC's summary directed attention to the passage quoted above.

In February 1967 a mutual funds conference was held at the University of Pennsylvania. Two Gaston Snow partners attended. (R.746-47) Loring discussed the conference with them and examined the transcript of it published in the March 1967 issue of the University of Pennsylvania Law Review. (Ex. 1-K, att. 1; R.752-53, 756)

At the conference there was discussion of the wide-spread mutual fund practice of using give-ups to encourage sale of fund shares and a brief reference to the PPI sentence about direction of give-ups to an NASD underwriter. (p. 834) Next, Philip Loomis (then the General Counsel of the SEC, now a member of the Commission) responded:

> "So long as the stock exchange rules permit this practice [customer-directed give-ups], it is to be expected that the funds will do something with these commissions, rather than not do anything with them. Thus, we view this as a problem of exchange rules, not as a practice in which the funds or their managers or the NASD or the I.C.I. [Investment Company Institute] are in any way delinquent." (p. 835)

Phillips, SEC Assistant General Counsel, reiterated this:

> "Now, to suggest that you tell mutual fund managers that they can't use this brokerage for sales, and to suggest that they have got to waste it, because they have no other use for it, just doesn't make sense." (p. 853)

Thus, Loring saw that the SEC officials attending the February 1967 conference did not suggest that NASD Recapture was practicable or lawful; plainly implied that no lawful "recapture" scheme existed; found no fault in the general practice of directing give-ups of fund commissions to encourage sales; and suggested that the basic area for reform lay in a direct approach such as introducing quantity discounts. Loring discussed the published report of the

conference with Johnson 2d and Sullivan, and advised them that it confirmed his prior views about the impossibility of NASD Recapture. (R.754-57)

However, in December 1967, unknown to the public or to FMR, a small mutual fund, Pro Fund, Inc., received a private indication from a staff officer at the PBW Exchange that PBW would tolerate NASD Recapture [12] (R.1927); and in 1968 Pro Fund began to "recapture." (R.3984)

On January 26, 1968, the SEC published for comment a proposed rule 10b-10 under which it would be unlawful for a mutual fund to direct a give-up on a securities transaction unless fees owed by the fund to its manager were reduced in the amount of the give-up. (R.3740-3752; see F.72, A.25). The SEC release alluded to the mutual fund organizations which had obtained Pacific Exchange memberships (R.3743; F.73, A.25; *supra,* p. 9, n.10), quoted the PPI sentence about NASD Recapture and declared that if a mutual fund manager could "recapture" give-ups, it was under a fiduciary duty to do so.[13] (R.3747) No instance of actual use of NASD Recapture was referred to in the release. (F.43, A.15)

On February 5 the Fund's directors voted to investigate the release (R.3375) and Fund counsel, Gaston Snow, assigned an attorney, Reilly, to work full time on the

[12] The advice was given in an unpublished letter dated December 14, 1967. (R.1927) This letter was the first indication by any exchange official of toleration of the direction of give-ups to a fund underwriter — an affiliate of a customer — for rebate to the customer. It is undisputed that the letter was given without any consideration of the antirebate provision of PBW's constitution. (R.3985, 1055, 1129-30, 1906; see F.71, A.25) Petitioners did not learn of the letter, still unpublished, until March 1968. (R.1050)

[13] Petitioners never disputed this general proposition in the Court of Appeals and agree that if NASD Recapture were legally available, they had a fiduciary duty to implement it. (Contrast B.7) However petitioners have always believed with the advice of counsel that NASD Recapture was not lawful.

matter (R.1029). He visited the major regional exchanges (R.1030-31) and summarized his investigation in a lengthy, detailed legal memorandum (R.1081-83) discussing the legal problems "recapture" presented on each exchange. (R.3976-4008; see F.76, A.26)

The memorandum tentatively indicated that, on the basis of the Pro Fund letter (which was shown to Reilly during his visit) and his interview with the PBW Exchange officials, NASD Recapture would probably be tolerated there (R.3984-87); and that, based on a conversation with the president of the Pacific Exchange, it would probably be tolerated there. (R.3998-99) The substance of the memorandum's recommendations was conveyed to the directors of the Fund at a March 28, 1968 meeting: that in order to minimize the risks of participating in the rebate scheme, any such participation should be at least on the basis of *written* advice obtained from officers of the exchanges. (F.99, A.34-35; R.3385)

Letters to the regional exchanges were then prepared by the Gaston Snow firm and sent. In May 1968, after a confirmation of the PBW Pro Fund letter (R.4506), FMR gave instructions that give-ups on the PBW Exchange were to be "banked" in the hands of the executing brokers.[14] In July 1968, after obtaining a letter from an officer of the Pacific Exchange indicating that NASD Recapture would be tolerated there, Crosby qualified as an approved non-member of the Pacific Exchange and a similar "banking" procedure was adopted with respect to transactions there.

The proposed SEC rule 10b-10 brought forth a storm of adverse comment and was never to go into effect. Many of

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[14] "Banking" is a term used by FMR for a procedure which it devised, whereby executing brokers were requested to hold "give-ups" against further instructions.

the commentators pointed out that the proposed rule was contrary to the exchange antirebate rules. (R. 4472, 4515, 4517, 4480, 4476) The Antitrust Division commented that the real problem lay in the minimum commission schedules, the existence of which tended to spawn "an array of devices and practices which raise serious questions of regulatory policy." (R.4456) On further consideration, the SEC requested the exchanges to introduce quantity discounts, to consider laying the ground-work for a system of negotiated commission rates on larger transactions, and to abolish customer-directed give-ups.[15] Under this pressure from the SEC, the exchanges announced their intention to abolish all customer-directed give-ups, a step which would make proposed rule 10b-10 moot; quantity discounts were also to be introduced. With the abolition of customer-directed give-ups imminent, on November 27, 1968, the board of the Fund met to decide what to do with the "banked" give-ups; they received advice from the law firms of Bingham, Dana & Gould and of Ropes & Gray to the effect that there were risks of illegality in either alternative — in recapturing the give-ups for the Fund or in directing them to other brokers. (F.80, A.27-28; R.4529) The board voted to recapture the "banked" give-ups for the Fund, with full realization of its questionable legality, as being at the time the less perilous of the two alternatives. (R.4527-28, 1377, 3245-46, 1659-61) The Fidelity group of funds thus became the first group ever to use NASD Recapture on the Pacific Exchange and the second to do so on the PBW. (See F.82, A.28) Effective December 5, 1968, customer-directed give-ups were abolished on all the exchanges. (F.35, A.13) Proposed rule 10b-10 was later withdrawn. (R.5402)

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[15] Letter from SEC Chairman Cohen to NYSE President Haack, May 28, 1968.

C. The District Court Decision

After a lengthy trial, the District Court dismissed the complaint on the merits. Most of the court's extensive findings and opinion related to the other charges made by plaintiff, but a substantial portion dealt with the charge that the defendants had been derelict in their duty in not employing NASD Recapture earlier than they did.

The District Court found that even where customer-directed give-ups were provided for, "no exchange would permit (and no informed person thought it lawful or ethical for) a broker to give-up or refund part of his commission to the customer directly. The obstacles were the exchange rules which established minimum rate schedules and prohibited rebates." (F.37, A.13) With respect to the assertion of the PPI report that NASD Recapture might be possible (*supra,* pp. 9-10), the court found that: "That statement was not buttressed by any legal analysis or precedent. No mutual fund or its underwriter had used such a device up to the time of the report. Moreover, that statement was in direct conflict with the text of, the policy of, and the then practice under the anti-rebate rules of every exchange." (F.69-70, A.24)

Commenting on the December 1967 letter of the PBW Exchange official to Pro Fund, the District Court found that: "The interpretation was sought at the suggestion of some SEC staff member, but it does not purport to consider the anti-rebate rules of PBW." (F.71, A.24-25)

The District Court also distinguished between a customer-directed give-up for the benefit of other brokers and one under which a rebate would be given to a customer: "a customer-directed give-up which was not used to establish a credit for a customer is no precedent for a customer-directed give-up which does establish such a credit." The

court held that devices such as NASD Recapture to which "plaintiff and some others give the name 'recapture methods', are rebates" and "have the evil consequence of giving back to the customer a dollar credit traceable directly or indirectly to the commission he paid." It held that "[t]hey are forbidden by the text and the policy of the minimum commission structure and anti-rebate rules" of the various exchanges. Following this Court's decision in *Silver* v. *New York Stock Exchange,* 373 U.S. 341 (1963), as to the rules of the exchanges, it held that "all recapture devices which are contrary to the anti-rebate provisions of exchange constitutions are illegal." (A.50-51)

D. The Court of Appeals Decision

The Court of Appeals, per Aldrich, C.J., reversed the judgment of the District Court insofar as it dismissed plaintiff's claims having to do with NASD Recapture. The Court of Appeals rejected the District Court's holding that this scheme constituted an unlawful rebate and summarily dismissed petitioners' contention that the scheme — unsanctioned as it was by any filing under or semblance of compliance with the Exchange Act — violated the antitrust laws. (B.23 n.19) The Court of Appeals held that the "controlling answer [to the question whether NASD Recapture violated the antirebate rules] must be found in how the exchanges, who were the rule-makers, themselves translated their rules" (B.24), and, since officials of two regional exchanges "chose to permit" the practice in 1968, it found that NASD Recapture was lawful at all times on those two exchanges.

Then, setting aside many of the District Court's findings of fact, the Court of Appeals proceeded to make its own findings *de novo.* It concluded that "in view of the PPI

report," petitioners should have employed the device of NASD Recapture from a date "no later than March 1, 1967." (B.30) This conclusion was reached in the face of uncontradicted evidence that the scheme had never been utilized prior to 1968, and that in February 1967, *following* the publication of PPI, SEC General Counsel and Assistant General Counsel stated that the practice of directing give-ups to brokers for selling fund shares was entirely proper since there was no other way in which a fund could make use of them.

The court proceeded to find Johnson 2d, Johnson 3d, FMR and Crosby, "guilty" of "gross misconduct" under Section 36 of the Investment Company Act of 1940 for failing to inform the unaffiliated directors of the Fund of the concept of NASD Recapture.[16] — Not even the plaintiff's briefs to the Court of Appeals had contended that this amounted to "gross misconduct" within the meaning of Section 36. — The court held that the omission to inform the whole board of a "matter . . . that could be thought to be of possible significance" (B.14) constituted "guilt" of "gross misconduct." And it held that motivation was irrelevant. (B.22 n.18) Thus, the court did not deem the petitioners' state of mind or good faith in not making disclosure pertinent to whether they were "guilty" of "gross misconduct." Nor did the court give any consideration to the fact that petitioners believed and had been consistently advised by counsel that the device of NASD Recapture was in fact unlawful — a belief scarcely unreasonable since the District Court later reached the same conclusion. The court included Johnson 3d in its finding of "guilt" although it never identified any connection he had with the matters discussed in the opinion.

[16] The Court held that Section 36 created an implied right of action for damages, and liability was established on this basis.

REASONS FOR GRANTING THE WRIT

I. The Court of Appeals in Holding NASD Recapture Lawful Sanctioned Discriminatory Price Fixing by Exchanges Contrary to the Securities Exchange Act and Outside That Act's Grant of Protection from the Sherman Act

The Court of Appeals in a short discussion reversed the District Court and held NASD Recapture to have been lawful. (B.22-25) For the Court of Appeals, it was enough that the officials of the PBW and Pacific Exchanges "chose to permit" it; legality was thereby established. The fact that no analysis of the rules of the exchanges could ever be made which would square NASD Recapture with the antirebate rules did not deter the court. Nor was the Court of Appeals deterred by the fact that all the other regional exchanges, when confronted with the scheme, construed their antirebate rules the way they were written — to forbid a rebate through the device of NASD Recapture. (F.41, A.14)

The Court of Appeals thus sanctioned a "split-level," discriminatory price-fixing scheme under which all other investors, institutional and individual, would pay the fixed minimum commission rates, while investment companies — *to whom alone rebates were available through NASD Recapture* [17] — would pay less. Since this arrangement was

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[17] This was so because on the two exchanges where NASD Recapture was tolerated, customer-directed give-ups to nonmember broker-dealers could be initiated only by "Investment Funds, registered under the Investment Company Act of 1940." See PBW Const., art. XX, § 2(b)(3), D.3; Pacific Rule IV, §§ 5, 5(b)(2), D.10-11. NASD Recapture, of course, depended on the initiation of customer-directed give-ups as a starting point for creating the rebate. This preferential discrimination was criticized by the Antitrust Division as a "distinction — not shown to be warranted — in the effective rates available to mutual funds, and those available to other institutional investors and to persons trading in large blocks." (R.4464)

not sanctioned under the statutory plan of the Exchange Act, it was unlawful both under that Act and under the Sherman Act; and even if it had been put into effect consistently with the Exchange Act, it still would have violated the Sherman Act.

1. The approach of the Court of Appeals might have some merit if the rules of the exchanges were rules of a private club. But they are far from that.[18] The cornerstones of the exchange rules having to do with brokerage commissions are the fixed minimum commission rules. These rules are the terms of what would be, in an industry not operating under the shield of the Exchange Act, an unvarnished horizontal price-fixing conspiracy. *Thill Securities Corp.* v. *New York Stock Exchange,* 433 F.2d 264, 269 (7th Cir. 1970), *cert. denied,* 401 U.S. 994 (1971); *cf. Silver* v. *New York Stock Exchange,* 373 U.S. 341, 347 (1963).

This Court has, however, held that an accommodation must be made between the Exchange Act and the Sherman Act in the area of concerted activities of stock exchanges and their members. There is thus an implicit repeal of the antitrust laws, but only so far as "necessary to make the Securities Exchange Act work, and even then only to the minimum extent necessary." *Silver* v. *New York Stock Exchange,* 373 U.S. 341, 357 (1963).[19] On this basis, stock exchange fixed minimum commission schedules have been held not to be, without more, a *per se* violation of the Sherman Act. *Kaplan* v. *Lehman Brothers,* 250 F. Supp. 562 (N.D. Ill. 1966), *aff'd,* 371 F.2d 409 (7th Cir.), *cert. denied,* 389 U.S. 954 (1967).

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[18] See *Silver* v. *New York Stock Exchange,* 373 U.S. 341, 351-52 (1963); *Baird* v. *Franklin,* 141 F.2d 238, 244 (2d Cir.), *cert. denied,* 323 U.S. 737 (1944).

[19] See also *United States* v. *Borden Co.,* 308 U.S. 188, 198-99 (1939); *Georgia* v. *Pennsylvania R.R.,* 324 U.S. 439, 456-57 (1945).

The Exchange Act — which is the basis for whatever implicit repeal of the Sherman Act is to be inferred in the area of concerted stock exchange activities — contains a detailed system of regulation of stock exchange practices through a continuing interrelationship between the registered exchanges and the SEC. Under Section 5 of the Exchange Act, transactions may not be effected upon a stock exchange unless it is registered under Section 6. To register, an exchange must file with the SEC "[c]opies of its constitution, articles of incorporation with all amendments thereto, and of its existing by-laws or rules or instruments corresponding thereto, whatever the name, which are hereinafter collectively referred to as the 'rules of the exchange.'" (Section 6(a)(3)) Any amendments to the rules of the exchange must be filed "forthwith upon their adoption." (Section 6(a)(4))[20]

Under Section 19 of the Exchange Act, the SEC is given continuing supervisory powers over exchange rules and activities, and may request exchanges to make rule changes; if an exchange fails to do so, the SEC is authorized "to alter or supplement the rules of such exchange" with respect to a number of specified matters, including "the fixing of reasonable rates of commission . . . ." (Section 19(b)(9))

The device of NASD Recapture, tolerated in 1968 by officers of the PBW and Pacific Exchanges — in contravention of the text of their antirebate rules and contrary to the

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[20] Pursuant to its rulemaking powers under the Exchange Act (Section 23(a)), the SEC has promulgated rules 6a-2 and 6a-3 (C.8-9) which require changes in the rules to be filed after their adoption, and rule 17a-8 (C.10) which requires each exchange to "file with the Commission three copies of a report of any proposed amendment or repeal of, or any addition to, its rules not less than three weeks . . . before any action is taken on such amendment, repeal, or addition by the members of such exchange or by any governing body thereof . . . ."

practice on every other exchange — was never embodied in a rule filed with the SEC under Section 6(a)(4), or as to which notice was given to the SEC under rule 17a-8. In a context where the published and sanctioned rules of the exchanges provided that every customer would pay identical commissions, the plain consequence of the clandestine scheme of NASD Recapture was that a select group of customers — investment companies — would obtain a preferential rate of commissions through a rebate.

Exemptions from the antitrust laws are narrowly construed.[21] This Court has held that where an immunity from the antitrust laws for concerted price-fixing is dependent upon making filings with a public body with a procedure for review, strict compliance with the filing requirements is necessary or *per se* liability under the Sherman Act results — with its consequences of treble damages and liability to criminal prosecution. *Carnation Co.* v. *Pacific Westbound Conference,* 383 U.S. 213 (1966). The antitrust laws are fully applicable "to the implementation of conference [or exchange] agreements which have not been subjected to public scrutiny and examination by a governmental agency." *Id.* at 219. *See Trans World Airlines, Inc.* v. *Hughes,* 332 F.2d 602, 610 (2d Cir. 1964), *cert. dismissed,* 380 U.S. 248 (1965). The informal letters of exchange officials which the Court of Appeals found sufficient here to amend the exchange rules and to legitimize a split-level commission system do not even approach the procedures for public filing, with the potential for SEC review — and participation by other agencies of the govern-

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[21] See, *e.g., Georgia* v. *Pennsylvania R.R.,* 324 U.S. 439, 456-57 (1945); *California* v. *FPC,* 369 U.S. 482, 485 (1962); *United States* v. *Philadelphia National Bank,* 374 U.S. 321, 350-51 (1963).

ment such as the Antitrust Division [22] — mandated by the provisions of the Exchange Act.[23]

Under the concerted arrangements here for the horizontal fixing of prices at different levels, access to the preferred price level was arbitrarily restricted. Whatever sanction the concerted price-fixing activities of the exchanges may have under the antitrust laws comes from compliance with the procedures under the Exchange Act, including the public filing of the rules effecting the price-fixing. Yet there never was any semblance of compliance with the Exchange Act in the case of the "split-level" price-fixing arrangements inherent in NASD Recapture.[24]

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[22] The Antitrust Division has played an increasing role in proceedings before the SEC having to do with exchange commission rate structures and membership practices. See, *e.g.*, its Comments in *Inquiry into NYSE Proposals to Permit Public Ownership of Member Corporations,* [Exchange Act] Release No. 8717 (November, 1969); Comments to the SEC in *Inquiry into Proposals to Modify the Commission Rate Structure of the NYSE,* [Exchange Act] Release No. 8239 (April, 1968), R.4452-68; Memorandum on the Fixed Minimum Commission Rate Structure in *Commission Rate Structure of Registered National Securities Exchanges,* SEC File No. 4-144 (January, 1969); and Response to SEC [Exchange Act] Release No. 8791 (March, 1970), in the same proceeding. Where the practices are clandestine, neither can the SEC exercise its regulatory role nor can the other agencies of government and the public participate.

[23] The Court of Appeals attempted to find support for its conclusion in the provisions of exchange constitutions that interpretations of the constitution or rules "by the exchange's governing body are final and conclusive." (B.24 n.20; see PBW CONST., art. III, § 21) The short answer is that there is no evidence that the Boards of Governors of the PBW and Pacific Exchanges (their "governing bodies") ever passed on what their officers were tolerating.

[24] The court below apparently attempted to justify its holding that NASD Recapture was not unlawful by analogizing it to a customer-directed give-up to another broker. (B.24) The court stated: "The very fact that one type of rebate was uniformly tolerated by the exchanges [meaning a customer-directed give-up to another broker] despite their anti-rebate rules in itself shows that logic alone cannot supply the answer." (B.24) The Court of Appeals should have indulged logic — and a reading of the pertinent materials — somewhat further. The fact of the matter is, of

2. Moreover, NASD Recapture would have been unlawful under the antitrust laws even if covered by a filing under the Exchange Act. Even in the case of a filed rule, antitrust immunity is conferred "only if necessary to make the Securities Exchange Act work, and even then only to the minimum extent necessary." *Silver* v. *New York Stock Exchange, supra,* at 357. See *FMC* v. *Svenska Amerika Linien,* 390 U.S. 238, 251 (1968). The federal courts have power under the antitrust laws to declare such a rule unlawful even though the SEC has never moved to set it aside. *Thill Securities Corp.* v. *New York Stock Exchange,* 433 F.2d 264, 269 (7th Cir. 1970).

As pointed out in the *Thill* case, it is hard to see how "discriminatory" rates — rates which are "not uniformly applied" — can be "necessary to make the Securities Exchange Act work."[25] 433 F.2d at 270. Whatever may be said in defense of price-fixing as opposed to competition — the usual justification being that it prevents "cut-throat" competition among firms in whose solvency there is a par-

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course, that the practice of customer-directed give-ups to other brokers was expressly sanctioned by the filed rules of the regional exchanges; NASD Recapture has never received that sanction. The practice described in the rules on file — customer-directed give-ups to other brokers — involves no rebate of money or credit to the customer (A.50-51); and, given an express provision for it in a filed rule, it clearly can stand with the anti-rebate rule. "The original thought behind our [customer-directed give-up] rule was to permit commissions to be shared among a wider group in the brokerage community." (Wetherill, President, PBW Exchange, R.4506) NASD Recapture on the other hand is a patent rebate, involving the maintenance of a split-level commission system for certain favored customers on the exchange. The Court of Appeals' equation of one with the other only underscores the erroneous holding of the court.

[25] The *Thill* case involved an attack on the alleged discriminatory enforcement of what was called the NYSE "antirebate rule", but was actually the NYSE classification of nonmember brokers as equivalent to members of the public, that is, as customers, thereby preventing members from sharing commissions with them. *Thill* did not involve any attack on the prohibition against rebating commissions to retail customers.

ticular public interest — there is nothing to be said for a hybrid system of split-level price fixing under which commission rates vary depending on the identity of the customer.

The District Court in *Kaplan* v. *Lehman Brothers, supra,* 250 F. Supp. at 565, in rejecting a *per se* attack on the minimum commission schedules of the exchanges, took pains to point out that: "It is not suggested by plaintiffs here that the rates are not uniformly applied, [or] that the schedules are discriminatory . . ." and that: "[t]he rates, once fixed, apply equally to all Exchange members and to all customers." When a private group has control over access to a market, the Sherman Act requires it to accord access to that market on an equitable and nondiscriminatory basis. See *Associated Press* v. *United States,* 326 U.S. 1 (1945); *United States* v. *Terminal R.R. Ass'n,* 224 U.S. 383 (1912); *American Federation of Tobacco Growers* v. *Neal,* 183 F.2d 869 (4th Cir. 1950). As the Antitrust Division has commented, there is no justification for granting access to preferential rates to mutual funds while denying it to other institutional investors. (R.4464) Channeling the forces of competition into the engrafting of special discounts onto a fixed-rate system is no substitute, under the Sherman Act, for the free play of the forces of competition; indeed it is, as the SEC's action in abandoning proposed rule 10b-10 indicates, a false step inconsistent with the goal of introducing competitive rates.

The Court of Appeals held petitioners guilty of "gross misconduct" for not having at an early date searched out and joined the scheme of NASD Recapture. But for petitioners to cause the Fund to participate in the scheme was to expose it to a charge that it had not only participated in a violation of the Exchange Act but had joined a conspiracy to violate the antitrust laws by engaging in an

unsanctioned price-fixing arrangement whereby commissions would through horizontal action be kept at a higher level for the disfavored group and at another, lower level, for the Fund and other favored parties.

II. In Finding Petitioners "Guilty" of "Gross Misconduct" De Novo on Appeal, the Court of Appeals Enunciated a Construction of Section 36 of the Investment Company Act at Variance with That Uniformly Applied in Other Circuits and Ignored the Petitioners' Good Faith Belief, with the Advice of Counsel, That NASD Recapture Was Illegal

Section 36 of the Investment Company Act, as enacted in 1940, authorized the SEC to bring an action against directors, investment advisers, and underwriters of registered investment companies. Under Section 36 if the court found the persons charged "guilty" of "gross misconduct" or "gross abuse of trust," it was required to enjoin them from serving in any such capacity to *any* registered investment company — in effect to put them out of the industry. Section 36 was originally drafted as a criminal provision, and its legislative history makes plain that it was directed against cases of "shocking abuse."[26] There have been only two reported cases — prior to this one — in which findings of "guilt" under Section 36 have been made; both cases clearly involved "shocking abuse."[27] The SEC, which is

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[26] S. 3580, 76th Cong., 3d Sess. (1940), § 17(e); *Hearings on S. 3580 Before a Subcommittee of the Senate Committee on Banking and Currency*, 76th Cong., 3d Sess. (1940), p. 40.

[27] *SEC* v. *Aldred Investment Trust*, 58 F. Supp. 724 (D. Mass.), *aff'd*, 151 F.2d 254 (1st Cir. 1945), *cert. denied*, 326 U.S. 795 (1946); *SEC* v. *Fifth Avenue Coach Lines, Inc.*, 289 F. Supp. 3, 13-23, 40 (S.D.N.Y. 1968).

primarily charged with the enforcement of Section 36, has made plain its view that the section is directed against serious quasi-criminal forms of misconduct.[28]

It was undisputed on the record that the Fidelity group of funds, although they embraced NASD Recapture reluctantly and with consciousness of its probable illegality, were the first fund group in the country of any substantial size [29] to engage in it; that they were the second to do so on the PBW Exchange and the first on the Pacific; that on the face of the published and filed rules of the exchanges, the practice was forbidden; that there has never been any plausible articulation of how the scheme can be squared with the language of the exchange rules; that in 1967 the SEC General Counsel in a public conference stated that mutual fund managers were not "in any way delinquent" in using give-ups to encourage brokers to sell fund shares; and that the few sparse references to NASD Recapture in the literature or on the public record do not purport to answer the basic difficulty of how the device could be squared with the antirebate rules. Moreover, even if the scheme should be thought lawful, at the pertinent times the petitioners sought advice of counsel and were advised that it was unlawful; they relied on that advice.[30]

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[28] "The express sanction in section 36 is seemingly directed more against persons 'guilty' of misconduct than the prevention of injury to an investment company. This may be due to the fact that it was originally drafted as a criminal provision. . . . The mandatory sanction of section 36 and the stigma that attaches to a finding of 'gross abuse of trust' tends to make action under section 36 an unduly harsh remedy for some types of misconduct encountered by the Commission in the administration of the Act." PPI, Ex. 6, p. 340.

[29] The only fund to engage in NASD Recapture before the Fidelity group was Pro Fund, Inc., which at the end of 1967 had approximately $4 million in assets. The combined assets of the funds managed by FMR at year-end 1967 were approximately $3.9 billion. (R.4139, 4253)

[30] The advice which the petitioners received as to the illegality of NASD Recapture was based on antitrust as well as other legal considerations. (R.2539, 4527; see also McKenzie, R.1481, 3292)

Nonetheless, the Court of Appeals proceeded to refind the facts — found by the District Court after a trial of over a month's duration — and to hold the petitioners "guilty" of "gross misconduct." Such a finding of "guilt" is a stain on the reputations of persons like petitioners whose business consists of managing other people's money.

In order to reach its extraordinary finding of guilt, the Court of Appeals held that the omission to inform the independent directors of any "matter . . . that could be thought to be of possible significance" (B.14) "however motivated" (B.22 n.18) — such as by the honest belief that it was unlawful and hence a "non-issue" — constituted "guilt" of "gross misconduct." The court never addressed itself to the elements which are necessarily embodied in such a finding of guilt. It read the element of bad faith or willfulness out of the statute.

1. The Court of Appeals' construction of Section 36 is in flat conflict with the recent construction by the Second Circuit in *Rosenfeld* v. *Black*, CCH FED. SEC. L. REP. ¶93,093 (2d Cir. June 22, 1971). In *Rosenfeld*, which was an appeal from a summary judgment for the defendants, the Second Circuit assumed that the facts as contended for by the plaintiff were correct — that one of the defendants had sold for money its fiduciary office as investment adviser. The court held that the conduct charged violated a common law fiduciary responsibility but could not amount to "gross misconduct." Said the court, per Judge Friendly: "Words and remedies such as these [in Section 36] were clearly addressed to highly reprehensible conduct . . .; we would not dream of suggesting, much less holding, that [the defendant's] actions were so culpable."[31] (*Id.* at p. 91,023)

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[31] To the same effect is *SEC* v. *Midwest Technical Development Corp.*, CCH FED. SEC. L. REP. ¶91,252, at p. 94,146 (D. Minn. 1963), where Judge Nordbye held that a violation of Section 36 "must be based upon evidence that a director is so untrustworthy that he should not be permitted to act in that capacity for any other [investment] company."

2. Not only did the Court of Appeals apply a totally novel and insupportable standard in finding the petitioners guilty of "gross misconduct", it proceeded to invade the trial court's province of finding the facts — provided by Civil Rule 52 — in doing so. The court thus brushed aside any consideration of the petitioners' good faith and reliance upon the resonable advice of counsel. All the Court of Appeals found was that: "the management defendants saw a question" (with respect to the availability of NASD Recapture in 1966 and 1967), did not seriously investigate it, and "all the record shows is that they discussed it among themselves." (B.16)

The facts of record are, rather, that immediately after the 1966 meeting with the SEC staff members petitioners sought advice of counsel; counsel investigated the available materials relevant to NASD Recapture — which of course no one was then engaging in; the matter was considered by partners in the firm of Gaston Snow; and counsel advised that NASD Recapture was prohibited by the antirebate rules. The evidence is also uncontradicted that the matter was further pursued intensively after the publication of PPI, including careful review by counsel of the transcript of the conference at which the SEC General Counsel spoke, confirming the unavailability of NASD Recapture.[32]

Instead of dealing with the issue as to whether the petitioners acted in good faith with the reasonable advice of counsel once it had disagreed with the fundamental holding of the District Court that NASD Recapture was in fact illegal, the Court of Appeals proceeded to find the petitioners "guilty" without analysis of this issue. The District Court had, of course, not made findings on this sub-

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[32] Petitioners did not take the position in the Court of Appeals that they had no duty to implement NASD Recapture if it were legal and "freely available." (*Supra*, p. 12, n.13; contrast B.7)

ject because it found NASD Recapture unlawful. To say that persons acting in an honest belief in the propriety of their conduct with the reasonable advice of counsel are to be found "guilty" of "gross misconduct" does violence to the text of Section 36 and to accepted principles of justice rising to constitutional levels. *Cf. Lambert* v. *California*, 355 U.S. 225 (1957).

The error is not mitigated because the Court of Appeals indicated that the gravamen of the petitioner's conduct was a failure to bring before the board as a whole the supposed question of NASD Recapture. The Court of Appeals acknowledged that if the device was in fact unlawful no duty would have been violated in not formally presenting it to the whole board. (B.22) Particularly in the context of a statute whose test is "guilt" of "gross misconduct" the same conclusion should follow where the petitioners honestly and reasonably believed the practice to be unlawful. And, as indicated previously, with the advice of counsel, petitioners believed prior to the SEC release proposing a rule 10b-10 that there was no "question" to be presented,[33] and they had every right to that belief.

The almost wanton disregard by the Court of Appeals for the record is most clearly seen in that court's conviction of Johnson 3d of gross misconduct. Because of Johnson

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[33] The Court of Appeals spent a substantial portion of its opinion in answering an alleged claim by petitioners that "they communicated" NASD Recapture to the unaffiliated directors. (B.17-19) The Court of Appeals misconstrued a response to an argument of plaintiff that petitioners had deliberately and affirmatively withheld from the unaffiliated directors, and suppressed, a variety of matters — PPI, the possibility of a membership on the Pacific Exchange, NASD Recapture, and others — as a "claim" that petitioners had brought up NASD Recapture before the whole board. This is not and never has been petitioners' position; that position has always been that they did not and need not have taken up NASD Recapture with the whole board prior to 1968. Nor have they agreed that the matter "routinely call[ed] for disclosure." (Contrast B.32)

3d's obvious lack of connection with the events in question he was not called at trial. He did not become a director of Fidelity Fund until April, 1968 (R.4076); the fund started "banking" give-ups through Crosby the next month. (F.78, A.27) His duties with FMR were overall administration of the research department and acting as an account manager of two other funds advised by FMR, not Fidelity Fund. (R.2903) Although he was an assistant vice president and later a vice president of Fidelity Fund (R.4209, 4241), he did not attend any Fidelity Fund board meeting of which the minutes are in evidence prior to 1968, and had no recollection of attending *any* Fidelity Fund board meeting prior to that date. (R.2921, 2911-20) His duties were not such as to impose upon him any personal obligation to investigate NASD Recapture and report on it to the board of Fidelity Fund. He did not attend the meetings with the SEC staff members (R.2111, 2168, 2955), and there is no evidence that he had any awareness of the sentence in PPI. The only specific mention of him in the Court of Appeals opinion is to identify him as a director of Fidelity Fund since April 1968 and as a director and a stockholder of FMR. (B.1-2) The court below in finding him "guilty" seems to have overlooked the fact that in our system of justice guilt is personal.

The action of the Court of Appeals in finding an innocent bystander "guilty" of "gross misconduct" underlines the egregious character of the decision below. Not only did the Court of Appeals promulgate an untenable standard of conduct under Section 36 of the Act, its free-wheeling departure from the normal course of judicial proceedings in making its own findings *de novo* on appeal invites, we submit, the exercise of this Court's supervisory power.

III. The Public Importance of the Questions

1. While the point on which guilt was found in the present case has to do with a specific scheme which was precluded in December 1968, review of the decision below, even on the narrowest view, is of great importance to the administration of justice in the federal courts. For there are currently pending in the federal courts more than fifty actions against mutual fund managements raising issues similar or identical to those at bar. These cases are pending in the First, Second, Third, Fifth, Ninth and Tenth Circuits. See Appendix E, which collects the cases. Plaintiff's counsel has been reported as admitting "that there are about 50 other suits swinging on this give-up decision."[34]

If the petitioners are to be condemned for not earlier taking action with respect to NASD Recapture, it is not apparent how any other mutual fund management will escape similar condemnation in the First Circuit or in any other circuit which applies the construction of "gross misconduct" adopted below. For the Fidelity group of funds were (with the single exception of the small Pro Fund) the first funds to employ NASD Recapture; it is hard to see how the management of any other fund could escape under the standard implicit in the Court of Appeals' opinion. The precise event which the court below held "as a matter of law" should have made the petitioners take action was the publication of the PPI report, with its single paragraph on NASD Recapture. (B.30) But that report was available to all mutual fund managements and was of general im-

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[34] Forbes Magazine, July 15, 1971, p. 63. Likewise the Wall Street Journal of June 7, 1971, reported: "Abraham Pomerantz, a New York lawyer who brought the suit in behalf of a Fidelity mutual fund holder, said there are about 50 lawsuits against mutual fund managers involving the same issue as the Fidelity case. 'Most of these cases have been held in abeyance pending the decision in this case,' Mr. Pomerantz said." (p. 5)

portance to the industry; a mutual fund management would be hard pressed to claim complete ignorance of it.[35]

There is a clear conflict of circuits as to what standard is applicable in determining whether the conduct of investment company managers constitutes "gross misconduct" or "gross abuse of trust." Under *Ross* v. *Bernhard*, 396 U.S. 531, 542-43 (1970), issues in the pending cases challenging fund brokerage practices will presumably be tried to juries; juries in the First and Second Circuits will be charged differently as between the decision below and the *Rosenfeld* opinion. There are at least 19 cases pending in the First Circuit and 30 in the Second Circuit. Resolution of the standard to be applied under Section 36 in the case at bar would advance the orderly administration of justice and assure equal treatment.[36]

Finally, the question whether NASD Recapture is unlawful is common to all the pending cases; if the scheme is unlawful there would unquestionably be a complete defense to the charges as to NASD Recapture in each case. An

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[35] While the court below placed some weight on the recorded interviews with SEC staff members held in 1965 and 1966, the record shows that similar interviews were held with the management groups of a number of mutual funds. (R.2294) In any event, the Court of Appeals' opinion makes plain its view that liability turned on the PPI report. (B.30)

[36] In 1970, as part of a general revision of the Investment Company Act, Section 36 was amended and now provides for a more flexible injunctive remedy, discretionary with the court, in cases of "breach of fiduciary duty involving personal misconduct." One of the purposes of the amendment of Section 36 was to quiet the "highly punitive overtones of the existing section." S. REP. No. 91-184, 91st Cong., 2d Sess., 3 U.S. CODE CONG. & ADMIN. NEWS (1970), p. 4931. Since Section 36 now imposes a less stringent standard, the decision below would appear to be *a fortiori* applicable under the amended section; under it, there is no telling what limits would be set to the practices of dubious legality which mutual fund managers would have to seek out and embrace on penalty of violation of Section 36.

authoritative resolution of that issue in this case is thus called for.

2. The importance of the underlying problem of the legality of NASD Recapture transcends the resolution of these pending cases; the propriety of granting preferential rebates to mutual funds is still with us.

To be sure, customer directed give-ups, on which the practice of NASD Recapture was in 1968 an excresence, have been abolished; and to some extent, the industry has been moved in the direction of some competition in commission rates, through the rule changes permitting negotiated commission rates on transactions in excess of $500,000. SEC, Exchange Act Release No. 9079 (February 11, 1971). But fixed rates otherwise remain, despite the partial relaxation. As long as this is the case, as the Antitrust Division has commented, rebate devices similar to NASD Recapture, ranging "from the indirect and ingenious to the bizarre and outright chicane" will proliferate. In many of these devices there will be "the discrimination inherent in their unavailability to certain classes of investors."[37]

If the decision below is not reviewed, there will be continuing compulsion on mutual fund managers to seek out and embrace these devices, however legally dubious. The recent "Martin Report" states that there are even today practices involving the splitting of commissions "where the result on some regional exchanges is a rebate or discount to an institutional customer." Martin Report (August 5, 1971) p. 11. The SEC last month in the context of fund brokerage declared that "Although give-ups . . . are now prohibited, reciprocal arrangements still exist on some ex-

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[37] Memorandum of United States Department of Justice on the Fixed Commission Rate Structure in *Commission Rate Structure of Registered National Securities Exchanges*, SEC File No. 4-144, January 17, 1969, pp. 73-74.

changes so that brokerage recapture[38] can still be achieved."[39] SEC Memorandum in Opposition to Proposed Settlement of *Gross* v. *Moses*, 67 Civ. 4186, S.D.N.Y., p. 9, n.11 (August, 1971).

The equivalent of NASD Recapture is presently tolerated — and hence lawful and obligatory under the Court of Appeals' rationale — on the Pacific, Detroit and Boston Exchanges.[40] Whether mutual funds may be afforded a special preference, and whether indeed they are to be required to seek out preferences — by way of procedures of dubious legality — on pain of statutory violation, is thus a question of substantial and continuing importance.

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[38] In the same document, the SEC defines "recapture" as "any means by which the brokerage commissions paid by a mutual fund . . . are reduced or *rebated*." (p. 4, n.3; emphasis supplied)

[39] The SEC has just announced a broad investigatory hearing on stock exchange practices generally, including questions going to "recapture of commissions"; and in an accompanying statement, SEC Chairman Casey deplored the "tendency for some of the most critical of these questions to be resolved not as a duly deliberated matter of broad public policy but as an expedient to effect short-run savings or to settle or avoid private lawsuits." Exchange Act Release No. 9315, August 26, 1971, and accompanying statement. These remarks have been interpreted as a reference to the response of the mutual fund industry to the decision below. See New York Times, August 26, 1971, p. 53.

[40] The Pacific and Detroit Exchanges have rules providing for a *discount* of 25% "[o]n business for approved non-members" (PACIFIC RULE IV, § 2; D.9) and a *discount* of 40% on trades for broker-dealers who are members of the NASD (DETROIT RULES, ch. VII, § 9(a); D.21). The reasoning of the letter of July 25, 1968, by the Pacific Exchange official permitting NASD Recapture (R.4061-62) is as much authority for passing the *discount* on to mutual funds as for passing give-ups on to them, and the practice is now being tolerated on that Exchange. Undoubtedly as a response to the Pacific Exchange, the Detroit Exchange has similarly interpreted its discount rule. See Memorandum, "Subject: Interpretation of 40% Commission Sharing (Access) Rule" (April 18, 1969). The Boston Exchange, on July 28, 1971, took action to permit funds to realize a discount by a procedure similar to that currently permitted by the Pacific Exchange.

CONCLUSION

Review of this case would present not only the sole opportunity for appellate review of the unwarranted sullying of the reputations of petitioners with an unsupportable conviction of "guilt" of "gross misconduct", but would permit this Court to resolve substantial questions of recurring importance, in litigation and in everyday practice, to the mutual fund industry.

For the reasons stated, this petition for a writ of certiorari should be granted.

Respectfully submitted,

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September, 1971

APPENDIX A

Opinion and Judgment of the United States District Court for the District of Massachusetts

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ROSE MOSES

v.

C. RODGERS BURGIN et al.

Civ. A. No. 67-880-W

August 18, 1970

As Amended August 27, 1970

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316 F. Supp. 31

FINDINGS OF FACT AND OPINION INCORPORATING CONCLUSIONS OF LAW

WYZANSKI, Chief Judge.

I.

Introduction.

This is a stockholder's derivative action brought against a mutual fund registered under the Investment Company Act of 1940, 15 U.S.C. secs. 80a-1 et seq., (hereafter called "the Act"), its directors, its investment adviser, and its underwriter. Plaintiff alleges that she through her company has been injured by defendants' violations of their statutory duties under secs. 1, 15, 36 and 37 of the Act, 15

U.S.C. secs. 80a-1, 15, 35 and 36, and of their non-statutory fiduciary duties.

Plaintiff's main challenge is to the practices followed by the mutual fund in (a) placing much of its portfolio brokerage (that is, orders for the purchase and sale of securities) with stockbrokers who as dealers had sold to the public new shares of the fund or who had provided statistical information for the fund or its manager and (b) directing such parts of a stockbroker's commission as he is willing to surrender, (that is, give up,) to other stockbrokers who had sold such shares or who had provided such statistical information.

In the language of the securities industry, the placing of portfolio brokerage with a stockbroker who has sold fund shares, or has supplied information, or otherwise served the customer is called "reciprocity"; the part of that stockbroker's commission which he retains is called a "reciprocal"; and the part which he surrenders to another stockbroker designated by the customer is called a "customer-directed give-up", or more simply and more usually a "give-up".

Stated broadly, the principal questions presented by this action are: (1) did defendants in placing the fund's brokerage on a reciprocal basis violate a statutory or non-statutory duty to secure for the fund the best execution of its purchase and sale orders; (2) did defendants in using the give-ups to stimulate sales of fund shares and supply of statistical information violate a statutory or non-statutory duty to secure for the fund a greater benefit by using the give-ups in some other way, such as by directing them to the fund's underwriter, or to a stockbroker affiliated with the fund or its management; (3) did defendants in taking into account sales of shares of, and information furnished

to, sister funds (into whose shares the shares of this fund were convertible) when defendants placed this fund's brokerage on a reciprocal basis and directed give-ups violate a statutory or non-statutory duty not to mingle the assets of different trusts; and (4) did defendants in omitting from the text of the investment advisory and underwriting contracts of the fund sufficient reference to reciprocal and give-up practices they followed rendered those contracts invalid under section 15 of the Act.

II.

Findings of Fact.

A. Parties

1. Plaintiff Rose Moses is and since 1960 has been a stockholder of Fidelity Fund, Inc.

2. Defendant Fidelity Fund Inc. ("FF"), a Massachusetts corporation, is an investment company or open-end mutual fund, registered under the Act, and seeking long term capital growth and income. As of mid-1968 it had net assets of over $834 million. In December 1967 it had 76,600 shareholders. FF is part of a group of 12 sister funds (hereafter collectively called "the Fidelity group"). They have different sizes and different investment objects, but they all have the same officers, directors, adviser and underwriter. As of mid-1968 the group had net assets of about $4 billion.

3. Defendant Fidelity Management & Research Company ("FMR"), a Delaware corporation, is the investment adviser of FF pursuant to annual contracts in purported compliance with Section 15 (a) of the Act. Under the con-

tracts, FF pays FMR an annual advisory fee equal to 0.5% of FF's net assets up to $200 million and 0.35% of all net assets in excess of that amount. FMR received in advisory fees from FF more than $2.7 million in 1967 and $3.1 million in 1968 and from the whole Fidelity group in 1967 about $14 million.

4. Defendant The Crosby Corporation ("Crosby"), a Delaware corporation, is a wholly owned subsidiary of FMR, and is an underwriter which has as its exclusive business selling at wholesale shares of the Fidelity group to independent securities dealers across the country who in turn sell them to prospective investors. FF, pursuant to annual contracts in purported compliance with Section 15(b) of the Act, sells its shares at their current asset value to Crosby, and Crosby and its dealers are authorized to make sale charges as set forth in a prospectus. The incoming shareholders pay these sale charges which start at 7½% of the offering price and scale down after $25,000, according to the amount of the sale. Of the sales charge Crosby retains a maximum of 1½%, and the dealer a maximum of 6%. Crosby received net underwriting commissions from new investors in FF in 1967 over $533 thousand, and in 1968 over $803 thousand.

5. Defendant Edward C. Johnson 2d is the president and a director of FF. He is also the president, a director, and the principal stockholder of FMR.

6. Defendant Edward C. Johnson 3d is a director of FF and of FMR.

7. Defendants Burgin, Harding, Hood, Jones, McKenzie, and Schermerhorn are or recently have been directors of FF, and each claims he is not "an affiliated person" within the meaning of Section 10(a) of the Act. These defendants call themselves "unaffiliated directors".

B. FF's Methods of Handling Brokerage

8. At all material times, FF, pursuant to its advisory contract, relied for investment advice as to which securities it should buy, sell, and hold upon the investment committee of FMR and of FF which reached its conclusions with the aid of FMR's research department.

9. FMR transmitted lists of securities to be bought, or sold, or held to a so-called portfolio manager, Joseph Midwood, a vice president of FF, but paid by FMR. He, within the framework of those lists, which constituted FMR investment committee authorizations, determined when a particular purchase or sale should be effected. He transmitted his determination to buy or sell a security to FF's trading department, headed by Miller Laufman, FF's manager of securities transactions, but paid by FMR.

10. Under Laufman's direction, the FF trading department decided through whom or with whom FF would execute the transaction specified by Midwood. At all times, the trading department was under instructions to check prices on all exchanges and on the third market in order to get always the best price, and also the best execution.

11. Examples of those instructions are to be found in what are called "reciprocal reports", that is monthly memoranda from D. George Sullivan, executive vice president of FF, and William L. Byrnes, vice president of FF. The earliest reciprocal report in evidence, the one for January 1966, states that "The Trading Department and the account managers should be always mindful that the persons we serve are the shareholders • • • ", and that "The Trading Department should continue to use and explore this [third] market, always in the interest of best execution." [Ex. 4A, pp. 2, 3]. The same themes appear consistently in later reports. [Ex. 4B, pp. 2, 3; Ex. 4C, p. 3; Ex. 4D, p. 3, etc.].

Thus the report for August 1966 directs that "In accordance with its usual procedure, the Trading Department should continue to check prices on the third market as well as those on the exchanges in order to get always the best price and, also, the best execution." [Ex. 4H, p. 3].

12. Subject to his over-all instruction that "the best price is paramount" [Ex. 4X, p. 3], Laufman used a list of 50 to 60 primary or lead brokers. This was a compilation of stockholders whom Laufman had investigated and of whose capacity to execute transactions he was satisfied. Sometimes Laufman, after investigation, added to that list a broker proposed by Sullivan, on the ground the broker had been successful in selling shares of FF or its sister funds.

13. When determining which broker to select for a particular transaction, Laufman had information from Crosby of the amount of Fidelity group shares each of the primary brokers had sold in the previous month. From that information he set up a quota system so that he could give in the current month each of the primary brokers business from which each would derive and retain commissions equal to at least one percent of his sales of Fidelity group shares during the previous month. Such retained commissions constituted "reciprocals" received by the primary brokers.

14. In the period when give-ups were allowed, that is, until December 5, 1968, before Laufman placed an order with a broker, he knew or learned whether the broker would submit to a give-up of part of his commission on that order. If the transaction did involve a give-up, Chester Hamilton, the treasurer of FF, but paid by FMR, wrote to the giving-up broker a letter identifying the transaction and directing to whom the give-up should be paid. When writing such a letter Hamilton had from Crosby a report showing sales

of Fidelity group shares by brokers in the previous month, and from FMR a report showing the value of statistical information supplied to FMR by brokers in the previous month. He allocated give-ups with the purpose and effect of making them roughly proportional to the sales made and statistical information supplied in the previous month.

15. Sullivan and Byrnes prepared, on a monthly basis, reciprocal reports to which reference has already been made. Those reports went not only to Laufman, as already noted, but to a list of FF officers and employees including Johnson 2d, Johnson 3d, Midwood, and Hamilton. The reports were prepared upon a group basis for all Fidelity funds, and did not segregate FF from its sister funds. The reciprocal reports showed, among other facts, what percentage of the group's brokerage commissions went to reward brokers who had sold new shares underwritten by Crosby, and to reward brokers who had provided research material. The reports also listed by name the 25 or so brokerage concerns most frequently used by the Fidelity group, and statistics showing in dollar and percentage terms what, if anything, each received on account of its sales of shares of the Fidelity group and on account of its supply of research information. Also the reports contained instructions and comments, such as those previously quoted.

16. Those reciprocal reports reveal the care with which allotments of the brokerage business were watched. The management of FF knew, as it stated in the reciprocal report for January, 1966, that "The SEC is very conscious of the distribtuion of commission business. Present procedures require a disclosure of each Fund's activities with respect to portfolio transactions. Undoubtedly this area will be one subject to much review by the SEC." [Ex. 4A, p. 2].

C. Whether FF Sacrificed Best Execution In Order To Reward Broker-Dealers With Reciprocals And Give-Ups

17. As already stated, the Trading Department was consistently directed to secure best execution. But the important question is whether those instructions were followed.

18. Laufman, who, as head of FF's trading department, was the person best qualified to know, was examined in a pretrial deposition and again at the trial with respect to how FF's brokerage business was actually handled. The general effect of his testimony was that it was the practice of FF always to insist on best execution in accordance with announced policy and specific directives.

19. Neither cross-examination nor independent evidence showed that in specific transactions FF could have achieved better execution.

20. Laufman's testimony as to FF's practice is supported by different types of evidence, which, admittedly, do not, even when taken cumulatively, embrace every individual FF transaction, but which, nonetheless, corroborate Laufman as to general practice.

21. Most significant is the substantial use by FF and others in the Fidelity group of the third market. The third market is a term used to describe brokers who trade listed equity securities over-the-counter. Third market brokers act as agents, in which case they charge commissions, or as principals, in which case they ordinarily charge a mark-up or mark-down. They are not subject to stock exchange minimum commission rate schedules. The usual price of a share is the last NYSE price plus or minus one-quarter of a point. But it requires high professional skill to discover

which, if any, third market broker at any given point of time will make a trade in a particular security on a better basis than is available on an exchange. The Fidelity group's net cost of trading on the third market was approximately 60% of the cost of trading on a stock exchange. This accords with the common experience of others.

22. The Fidelity group has used the third market far more than any other mutual fund. In 1966 the group executed on the third market 6.91% of its transactions; in 1967, 9.6%; and in 1968, 10 to 12%.

23. Plaintiff attempts to belittle those percentages. She notes that after give-ups had been abolished in December 1968, Fidelity did more of its trading on the third market. But the very document from which plaintiff drew that information explained that the reason Fidelity's use of the third market rose in 1969 was that with the termination of customer-directed give-ups more institutions were coming to the third market as a source for the purchase and sale of larger blocks of securities. [Ex. 41, p. 6].

24. Plaintiff also claims that FF used the third market less than did pension funds and other institutional investors. There is no proper foundation for such a claim. What plaintiff cites is not testimony offered in this case and subject to cross-examination, but a statement in the SEC "Special Study of Securities Markets" H.R.Doc. No. 95, 88th Cong. 1st Sess., p. 881. That statement purports to show that in March 1961 pension funds did 18.7% of their business in the third market. We cannot tell whether securities traded by pension funds are comparable in type or quantity with Fidelity's trades, whether March 1961 is a typical month, or indeed whether the trades were at better execution than stock exchange trades of those securities would have been.

25. Another indication that in practice FF sought best execution is that such a substantial amount of its business went to brokers who must have been chosen solely for excellence in performance inasmuch as they did not sell Fidelity shares or supply FMR with statistical information.

26. For example, of FF's 10 top brokers based on total amount of business done in 1967 in terms of the value of shares traded, 8 were non-sellers. And of the 10 largest broker-dealers used by the Fidelity group as a whole in *principal* transactions (which may not be wholly representative because so many of the securities involved would carry only a small commission) in 1966, 8 were non-sellers; in 1967, 8; and in 1968, 7.

27. Of course, the statistics recited do not foreclose the *possibility* that *some* of the business which went to sellers could have been better executed by non-sellers. Therefore, before using Laufman's testimony and the corroborating evidence as the basis for a finding that best execution was *regularly* achieved by FF, it is necessary to examine countervailing considerations.

28. Laufman, like every employee and officer of FF was paid by FMR. It would have been to FMR's advantage always to give enough of FF's brokerage business to fund sellers so that each of them would get substantial rewards. It might be that FF could not always get enough reciprocals and give-ups to assure substantial rewards *solely* from best execution. However, that is merely a speculation. There is not any evidence to show that best execution would have failed to supply sufficient reciprocals and give-ups or that there ever was any pressure upon Laufman to do more business than he was doing with brokers who would submit to give-ups. On the contrary, he was urged to use the third market more. Furthermore, there is no evidence that

Laufman was the sort of man who could be diverted from his duty to FF because FMR paid him out of the fees it received from FF.

29. Plaintiff seems to argue that if the court considers as significant the number of non-sellers used by FF as brokers, it ought to regard as even more significant the number of sellers used by FF. Such an argument would be fallacious. Every time FF used a non-seller it may fairly be inferred that it was acting on the basis of best execution because it would have no other probable motive. The converse is not true. When FF used as its broker a seller it may not fairly be inferred that FF was not seeking best execution. It is possible, and indeed highly probable, that often best execution was available through either a seller or a non-seller, and that the choice of the seller as broker was consistent with FF's statements in its proxy material that "relative sales of the shares of all of the Funds * * * and statistical and other factual information provided * * * are taken into account where there is no competition among dealers on the basis of price." [Ex. 17-A-5, p. 7].

30. What has just been said disposes of another of plaintiff's contentions. She finds some significance in the fact that only after give-ups became available on certain regional markets did FF use brokers on those markets. Such use of a regional broker does not justify any inference that before give-ups became available he alone offered best execution. If the regional broker offered only the same execution as a NYSE broker, it was consistent with FF's declared policy not to use the regional broker when there were no give-ups on the regional exchange, and to use the regional broker at least some times when give-ups became available.

31. Plaintiff notes that on occasion FF used a broker who did not have a direct wire to FMR or used an inexperienced broker. It is, of course, possible that in a particular transaction such a handicap precluded best execution. But there is no proof that such was the case. An inferior broker in the transactions entrusted to him may have rendered best execution, and indeed may have been given an order at a particular price or other condition which assured best execution. Laufman's testimony is not to be impeached by speculation that good results may not have been achieved.

32. The last sentence applies also to plaintiff's suggestions that best execution may not have been secured by using sellers of shares as managers of secondary distributions. Of course, it may be that on some occasions a non-seller would have been better. But there is no reason to assume so, or to conclude that competitive bidding would have been likely to produce a better execution than private negotiation. Moreover, since about half the secondary distributions were managed by brokers who were not sellers of Fidelity group shares there is sound ground for finding that best execution was always sought with respect to secondaries.

33. After considering the foregoing and other contentions of plaintiff and the evidence as a whole, and even assuming that defendants have the burden of proof, this court is satisfied that as a matter of practice FF did achieve best execution in its brokerage business. It did not allow considerations relating to the sale of Fidelity shares or to the supply of statistical information to impede or affect its primary concern to obtain the most favorable price for fund portfolio transactions.

D. The Stock Exchange Rules Within Which FF's Methods of Allocating Give-Ups Developed

34. So far we have been principally concerned with the facts relating to the first question presented, that is, did defendants in placing the fund's brokerage * * * secure for the fund the best execution of its purchase and sales orders. Now we turn to findings of fact bearing on the second question presented, that is, did defendants in using the give-ups to stimulate sales of fund shares and supply of statistical information violate a statutory or non-statutory duty to secure for the fund a greater benefit by using the give-ups in some other way, such as by directing them to the fund's underwriter, or to a stockbroker affiliated with the fund or its management.

35. Initially, we must attend to the framework of stock exchange constitutions and rules in which customer-directed give-ups were tolerated until abolished December 5, 1968.

36. The practice of permitting customer-directed give-ups had existed at least since the 1950's. It developed at a time when no exchange allowed volume discounts, but brokers sought to attract large orders by giving up part of their commissions as the customer should direct.

37. Even when give-ups were tolerated no exchange would permit (and no informed person thought it lawful or ethical for) a broker to give-up or refund part of his commission to the customer directly. The obstacles were the exchange rules which established minimum rate schedules and prohibited rebates.

38. Typical is the following provision in Article XV, section 1 of the NYSE constitution:

> "Commissions shall be charged and collected upon the execution of all orders for the purchase or sale for

the account of members or allied members or of parties not members or allied members of the Exchange, of securities admitted to dealings upon the Exchange and these commissions shall be at rates not less than the rates in this Article prescribed; and shall be net and free from any rebate, return, discount or allowance made in any shape or manner, or by any method or arrangement direct or indirect."

39. Similar provisions are in the constitutions of all the regional exchanges: Boston Stock Exchange constitution, art. XVIII, secs. 1-4; Detroit Stock Exchange constitution, art. XVIII, secs. 1-4; Midwest Stock Exchange Rules, art. XXIX, rules 1-21; Pacific Coast Stock Exchange constitution, art. XIV, secs. 1-8; and Philadelphia-Baltimore-Washington Stock Exchange ("PBW") constitution, art. XX, secs. 1-9.

40. The NYSE interpreted its anti-rebate rule as permitting a NYSE broker to submit to his customer's direction to give up part of the commission to another broker who belonged to the same exchange, but to no one else.

41. The regional exchanges differed. Midwest adopted a rule which reached substantially the same result as the interpretation issued by the NYSE. Midwest Rules, art. V, rule 9. Boston and Detroit allowed give-ups to be directed to members of the NASD who were not members of their respective exchanges. Boston Rules, ch. VII, sec. 4, and Detroit Rules, ch. VII, sec. 9(b). Neither Boston nor Detroit ever interpreted its give-up rule to allow a credit back to the customer. The Philadelphia-Baltimore-Washington exchange (PBW) by art. XX, sec. 2(b) of its constitution permitted a give-up to a member of the NASD under certain circumstances. The Pacific Exchange limits

give-ups to members and approved non-members. Pacific rule IV, sec. 5(b) (2).

E. Other Suggested Methods of Handling FF's Brokerage

42. Much of the evidence in this case is addressed to the issue whether if FF had not used its brokerage give-ups to reward brokers who sold Fidelity group shares or provided research information, FF could have made other choices to the greater advantage of FF's stockholders.

43. Plaintiff speaks of those other choices as methods of "recapture" of the give-ups. The term "recapture" was used (perhaps for the first time) in connection with give-ups at The Conference on Mutual Funds held at the University of Pennsylvania on February 9 and 10, 1967. See 115 U. of Pa.L.Rev. 662, at 832-834. [Ex. 1-K, Att. 1, pp. 832-834]. Inasmuch as no informed person supposes that under the rules of any exchange the customer may recover directly from the broker any part of the commission, there is no lawful possibility of a "recapture" in the ordinary sense of the word. What plaintiff and others who use the word "recapture" have in mind is the use of give-ups so that the recipient will credit, or arrange for a credit to the benefit of the customer.

44. Many of the suggested ways of using give-ups involve, as Philip A. Loomis Jr., General Counsel of SEC, remarked at the 1967 University of Pennsylvania conference, "intricacies, distortions and artificialities". [Ex. 1-K, Att. 1, p. 836]. But two of the suggestions, even if somewhat devious, require full exploration. One is the placing of portfolio brokerage with, and the direction of give-ups to, a broker affiliated with a mutual fund adviser; the other is the direction of give-ups to the mutual fund's underwriter. Those two suggestions involve such different tech-

niques that it obfuscates the problems presented by each if they are approached under the broad rubric of "recapture".

F. Possible Placing of FF's Portfolio Brokerage With, and Direction of Give-Ups to, an Affiliated Broker

45. Plaintiff contends that FF could have required FMR to have become a member of NYSE; then FMR could have collected all or part of FF's portfolio brokerage commissions, and could have credited them against the advisory fees payable by FF. Alternatively, plaintiff says, FF might have retained a NYSE member firm as investment adviser, with brokerage commissions applied to reduce or extinguish the advisory fee.

46. Both those proposals, (and variations of them which can be conceived,) are necessarily premised on the supposition that it would have been the business judgment of the directors of FF and FMR that it would be desirable for this particular mutual fund (with the history and purposes of FF, with the basis on which it had attracted and hoped hereafter to attract investors, and with the difference from competitive funds it had sought to maintain) to be in such close relation to the brokerage business. In finding the facts, no less than in reaching any conclusions of law the first inquiry, therefore, is what was the business judgment of the directors of FF and FMR. Indeed the central importance of this point has been recognized by the SEC, as shown by its Exchange Act Release No. 8746 (Ex. A-64), from which the following quotation is taken:

> "You first ask whether mutual fund management has a fiduciary duty to acquire a stock-exchange seat, directly or through an affiliate, in order to utilize this means to recapture brokerage which in turn will be offset against management charges. We do not believe

that management has this duty if in the exercise of its best business judgment management determines that it is not in the best interest of the fund to create such an affiliate."

47. Although plaintiff argues otherwise, there is abundant proof that the directors of FF and FMR had often addressed their attention to the possibilities of a broker-affiliate and rejected, on objective grounds that were wholly reasonable, any restructuring of FF's adviser so as to involve it in the brokerage business.

48. Johnson 2d had for years considered whether FMR should form or acquire a brokerage affiliate. He felt brokerage was so different a business that it would distract FMR from its primary advisory and management functions. He also felt that such an arrangement would tend to reduce the probability of FF getting best execution of its orders.

49. FF's unaffiliated directors were equally hostile to proposals involving the use of an adviser that had a broker affiliate or was itself a broker. They thought that the brokerage and investment businesses did not mix. They feared that benefits produced through advisory fee credits might be lost through poorer executions. They were mindful that broker-affiliates might lead, justly or not, to charges of churning, of increasing portfolio turnover simply to increase the amount of savings of advisory fees, of transactions at prices below best execution, and even of failing to use sufficiently a brokerage affiliate lest management lose part of its advisory fee. They knew that the proposals might lead to vexatious litigation difficult to defend. They foresaw that if the mutual fund used only one broker for most of its transactions, it would increase the likelihood of general disclosure as to who was the principal in the trans-

action, and might produce a market reaction prejudicial to the fund.

50. That such grounds for being opposed to broker affiliations were entirely rational and consistent with prudent business judgment is sufficiently attested by the Report of The Securities and Exchange Commission on the Public Policy Implications of Investment Company Growth, H.R. No. 2337, 89th Cong., 2nd Sess. (December 2, 1966) [Ex. 6] (hereafter PPI). The SEC pointed to the "ever-present potential for abuse inherent in investment company-broker relationships" (p. 190), "For example, such affiliations could possibly lead investment company managers to adopt investment policies that call for high portfolio turnover rates for the purpose of increasing the amount of brokerage commissions obtainable through their relationship with the companies" (p. 189). "Close affiliations between broker-dealers and investment companies also raise questions relating to the fulfillment of the investment company managers' duty to seek the best execution of portfolio transactions. If its affiliated broker-dealer is an exchange member, the manager of an investment company may be less inclined to consider opportunities for best execution in the third market where the affiliated broker could not earn an exchange commission" (p. 189). [See the unreported and not necessarily well-founded complaints in *Josephson* v. *Campbell,* S.D.N.Y. 1969 and *Horenstein* v. *Waddell & Reed, Inc.*, 67 Civ. 4175, S.D.N.Y.1970.]

51. Plaintiff is mistaken in supposing that all the objections raised by the directors would necessarily be obviated if the broker-affiliate operated without a profit and if the broker-affiliate instead of executing transactions was merely what is called an introducing broker.

52. A profitless broker would still have to pay its operating and capital costs.

53. Moreover, the proposal of an introducing broker, who merely gave orders to other brokers to execute, is an idea that no mutual fund has ever tested in practice and which may be full of pitfalls. Even on the assumption that any exchange would tolerate such a blatant institutional circumvention of its anti-rebate rules, an introducing-broker-affiliate, like any other broker-affiliate, would involve a mutual fund and its adviser in many of the disadvantageous consequences feared by Johnson 2d, by the unaffiliated directors of FF, and by others who have eschewed combining investment and brokerage operations in one complex. The least that can be foreseen is that such a relationship would so alter the posture of FF and FMR that it would affect those who had selected, or might select, FF shares as an investment for the very reason that, unlike some other well known funds, FF was wholly independent of any broker as manager or managerial affiliate. Furthermore, such a relationship would necessarily divert to some degree the attention of the managers of the fund from advisory problems to brokerage problems.

54. Quite apart from whether as a matter of business judgment of FF's and FMR's directors a broker affiliation would have been a sound course, most of plaintiff's suggestions of broker affiliation could have not been realized under the constitution and practices of the NYSE or probably any regional exchange.

55. NYSE consistently in public statements and actions has opposed the admission to membership of an institutional investor seeking to circumvent its anti-rebate rules.

56. Neither FMR nor a broker subsidiary it organized would have overcome that consistent NYSE position or the

bar created by Article IX, sec. 7(b) (4) of the NYSE constitution which provides that:

> "(b) The Board of Governors shall not approve a corporation as a member corporation unless:
>
> • • • • • •
>
> (4) a primary purpose of such corporation is the transaction of business as a broker or dealer in securities. • • •

As used in that constitutional provision the phrase "a primary purpose" has been construed to mean "the primary purpose". [See letter dated October 31, 1969 from the president of the NYSE (Ex. A-65)]. And there can be no reasonable doubt that, regardless of what proportion of the revenues of a concern like FMR came from brokerage, its primary purpose, to which all other purposes are and would be ancillary, is the management of mutual funds to which it renders advisory service in accordance with the Investment Company Act. The test of whether an applicant is primarily a broker or dealer turns on whether it bona fide engages in the brokerage business in a general way, not necessarily offering the public to handle anyone's account but with the predominant purpose of performing a professional function in the market rather than of serving solely as an adjunct to a particular customer's institutional business.

57. Another reason that FMR, as now-structured, could not become a member of NYSE is that at all times one of FMR's three voting stockholders, has been Homer Chapin, a full time officer of Massachusetts Mutual Life Insurance Company, and Article IX, sec. 7(b)(2) of the NYSE constitution prohibits a corporation from becoming a NYSE member unless "every holder of voting stock • • • actively

engages in its [the applicant corporation's] business and devotes the major portion of his time to it."

58. Parallel considerations to those which would have barred FMR from becoming a member of NYSE would also have barred Crosby. Crosby's sole business is that of being an underwriter. It is really a selling agent who (unlike a conventional underwriter) does not bear the risk that the securities will be unsalable. [See PPI p. 55, n. 137 (Ex. 6)]. Crosby's primary purpose is not "the transaction of business as a broker or dealer in securities", as that phrase is used in Article IX, sec. 7(b)(4) of the NYSE constitution, because it does not bona fide engage in the brokerage business in a general way with the predominant purpose of performing a professional function in the market. Another reason that Crosby would have been ineligible for membership in the NYSE is that all of Crosby's stock is owned by FMR, which would make Crosby unable to comply with the condition prescribed by Article IX, sec. 7(b)(2) of the NYSE constitution that a corporate applicant for membership shall not be approved unless "every holder of voting stock in such corporation * * * is an officer or employee of such corporation."

59. The considerations which would have prevented Crosby from becoming a member of NYSE would also have prevented a subsidiary of FF from acquiring membership. Moreover, [despite the statement in PPI p. 173, footnote 82, (Ex. 6)] Section 12(d)(3) of the Act would have prohibited FF from owning a subsidiary engaged in the brokerage business. See Sen.Rep. No. 1775, 76th Cong., 3d Sess. 15-16 (1940).

60. Factors which would block FMR and subsidiaries of FMR from membership in NYSE, of course, would apply to any other investment adviser with a comparable struc-

ture. To be sure, those factors would not prevent an established broker already a member of NYSE from being retained by FF as an adviser. However, it is not true that the brokerage commission business and the give-ups such a broker received on account of FF trades could be used to reduce all aspects of the advisory fee. The only part of the advisory fee that could be credited with brokerage is that miniscule portion of the advisory fee which covered publications such as investment letters, loose-leaf and like investment services, and the conventional statistical information stockbrokers give customers in return for their business. [See what is called "NYSE Rule 440A", a provision which may not in fact be a rule. See *DeRenzis* v. *Levy*, 297 F.Supp. 998, 1000-1001 (S.D.N.Y.)]. The anti-rebate rule of the NYSE would not permit a credit against that part of the advisory fee which represented research in depth or which represented managerial advice beyond what brokers customarily give customers.

61. The same considerations which would have prevented FMR or any subsidiary of FMR from becoming a member of the NYSE would have been applied at all times relevant to this action by almost every, if not every, regional exchange.

62. It is true that in 1965 the Pacific Exchange, under its then rules, had permitted a broker affiliate, organized as a subsidiary of Waddell and Reed, the manager of United Fund Inc. to become a member. Membership had been accorded also to subsidiaries of three other adviser-underwriters: Investors Diversified Services, Inc., Channing Financial Corp., and Imperial Services, Inc. But in each of the four cases the subsidiary broker dealt directly with the public and thus was involved in activities that FMR, Crosby and FF have shunned for reasons already stated.

63. FMR and Crosby, since they did not deal with the public, were not admissible to membership in the Pacific Exchange either before or after the changes in its rules made in July and September 1965. There is in the record before this court no basis on which to suppose that Pacific's rule was in violation of the anti-trust laws. On the contrary, the distinction Pacific drew between brokers dealing with the public and brokers not so dealing had a justification which *prima facie* was valid.

64. To conclude this section of the findings, the court finds that as a matter of fact there were sound business and legal reasons for the directors of FF not to have sought to place FF's portfolio brokerage with, and direct FF's give-ups to, an affiliated broker of any kind; and that those reasons did motivate the directors in not making arrangements with FMR or others for such an affiliated broker.

G. Possible Directing of FF's Give-Ups to Crosby

65. The possibility of a mutual fund directing its give-ups to its underwriter which in turn would give the fund cash or credit seems to have been first suggested by an employee of the SEC, Silver, on June 3, 1965. At a hearing merely to gather information with respect to "Trading on the Detroit Stock Exchange and Off-Board Trading by Exchange Members", Silver interjected the suggestion that "a rebate (sic!) of commissions" to Crosby thence to FF might be achievable on the Detroit Stock Exchange, under the present rule without being a member. [Ex. 1-C, Att. 1, p. 44].

66. When Silver made the suggestion and at all other times there was no reason to suppose that it complied with the anti-rebate rule of the Detroit Stock Exchange.

67. A year later, in September 1966 at a hearing on "Commission Rate Structure" another employee of the SEC, Rotberg, asked questions about the possibility of FF using Crosby as a member of a regional exchange to get give-ups with which Crosby could then credit the fund. [Ex. 1-C, Att. 1, pp. 41-44]. Again there was no reason to suppose that this tactic would be permissible under the anti-rebate rules of any exchange.

68. In December 1966 the SEC in its *Report on the Public Policy Implications of Investment Company Growth* stated at p. 173:

> "It would not be inconsistent with those [regional exchange] rules for dealer-distributed funds to direct give-ups to their adviser-underwriters, all of whom are NASD members, for the purpose of applying these give-ups to reduce the advisory fees payable by the funds."

69. That statement was not buttressed by any legal analysis or precedent. No mutual fund or its underwriter had used such a device up to the time of the report.

70. Moreover, that statement was in direct conflict with the text of, the policy of, and the then practice under the anti-rebate rules of every exchange.

71. In December 1967 the Philadelphia-Baltimore-Washington Stock Exchange for the first time gave an interpretation that permitted a PBW member at the direction of a mutual fund to give up commissions to its NASD underwriter for the purpose of crediting them against expenses of that mutual fund. The interpretation involved a mutual fund, Pro Fund, Inc., and its adviser, Pro Services, Inc. which was under common control with a PBW member, Cannon & Co. Inc. The interpretation was sought at the

suggestion of some SEC staff member, but it does not purport to consider the anti-rebate rules of PBW.

72. January 26, 1968 the SEC issued Release No. 8239 proposing a new Rule 10b-10 under the Securities Exchange Act of 1934 [Ex. 9.] The release stated that:

> "The rule, essentially, would prohibit investment company managers from directing brokers executing transactions for an investment company to divide their compensation in any way with other brokers unless the benefits of such division accrue to the investment company and its shareholders."

73. Page 4 of the release mentions "procedures which have been developed and which enable institutional investors to recapture a portion of commissions for themselves." Without specific citation, the release considers the cases in which a mutual fund manager had created a broker-affiliate which joined a regional stock exchange. This, of course, is an indirect reference to Waddell & Reed, Inc., Investors Diversified Services, Inc. and the other two cases on the Pacific exchange. No reference is made to any other type of "recapture" nor to any case where give-ups have been directed to an affiliated underwriter who is an NASD member.

74. The release invited all interested persons to submit their views and comments on Rule 10b-10.

75. After reading this release, Sullivan of FF and FF's general counsel determined to learn whether there were in fact any "recapture" procedures which did not involve the creation of a broker-affiliate. Accordingly, they requested Gaston, Snow, Motley and Holt, the firm which has for many years been the legal adviser of FF and FMR, to investigate all possibilities of recapture on the regional ex-

changes. That law firm assigned one of its lawyers, Richard M. Reilly, to make an investigation with respect to the possibilities of recapture on all the regional exchanges.

76. Reilly visited each regional exchange to learn the answers to the following three basic questions, to which he referred in a memorandum he prepared on March 25, 1968 on the subject of "'Recapture' potential on Regional Stock Exchanges" [Ex. 13, p. 1]:

> "1. Would it be possible for the Fund directly or indirectly to 'recapture' give-up on commission business it had placed on that exchange? 2. Would it be possible for the Fund or a subsidiary to qualify for a discount in commission charges on exchange transactions? 3. Would it be possible for the Fund or a subsidiary to qualify for exchange membership?"

It is unnecessary to summarize the memorandum as a whole. But it is here relevant to note that PBW and Pacific both indicated that FMR might be able to use Crosby as a member of NASD in the case of PBW and as an approved nonmember of Pacific to receive give-ups which could then be credited against the advisory fee payable by FF to FMR. However the memorandum emphasized that its conclusions were "tentative at best" (p. 28). The memorandum then stated (pp. 28-29):

> "It is to be expected that before definitive decisions would be made the Board of Governors of the various exchanges will be consulted to determine policy and it is likely that the exchanges may delay decisions until the present confusion in the area has settled and certain patterns have emerged. Present plans call for the submission of detailed letters to each of the above exchanges asking for rulings as to the permissibility of the various trading techniques that could result in

savings to the fund. With the exception of Philadelphia, none of the exchanges have ever taken official positions on the issues that will be raised in the various letters. It is probably safe to say that none of the exchanges, including Philadelphia, has thought through all the problems."

77. Moving slowly, Reilly prepared for FMR follow-up letters to PBW and Pacific to inquire about the possibility of using Crosby to receive give-ups which could serve as a basis for FMR giving FF credit on its obligation to pay advisory fees.

78. With respect to PBW, FMR wrote on May 24, 1968. But FMR did not wait for an answer. When FMR saw that PBW wrote to the SEC in commenting on proposed rule 10b-10, FMR, beginning May 29, 1968, instructed the PWB exchange brokers with whom it dealt to "bank" give-ups, that is to hold the portion of the commissions which they were prepared to surrender so that, if permissible, FMR could direct them to Crosby, and FMR could credit FF against its advisory fee obligations. By November 1968, the banked give-ups on PBW totalled $18,427.58.

79. With respect to Pacific, FMR wrote on May 27, 1968. Pacific on July 27 confirmed that Crosby could be an approved non-member and thus receive give-ups which would serve as the basis of credits from FMR to FF. The next day FF's directors directed its Pacific brokers to bank give-ups. By November, 1968, the banked give-ups on Pacific were about $22,000.

80. On November 27, 1968, Edward B. Hanify, of Ropes and Gray, and Sumner H. Babcock, of Bingham, Dana, and Gould, acting respectively as counsel for FMR and its unaffiliated directors, advised the board of FF that it was a

question of business judgment whether to direct the banked give-ups to Crosby. Counsel said that there was a risk that the direction would be unlawful as being in violation of the anti-rebate rules, but there was also a risk that the chance to make the direction would be lost in a month when the rules abolishing give-ups became effective [Ex. 38].

81. As a matter of business judgment the directors of FF directed that the give-ups banked on PBW and Pacific be given to Crosby so that FMR would credit FF.

82. The foregoing account leaves for later consideration the degree to which the events recited were known to the directors of FF. But the account is complete in the sense of mentioning every known instance of the use by any fund of its underwriter to "recapture" give-ups.

83. There is no ground for supposing that there were other instances. On July 23, 1968 FMR gave the SEC a statement respecting give-up recapture [Ex. 1-H, Att. 7]. FMR told of the steps it had taken to investigate the accuracy of the SEC declaration in Release No. 8239 that mutual funds could "recoup substantial amounts of commissions paid for the execution of their portfolio orders". FMR gave SEC copies of its exchanges of letters with regional exchanges. Then FMR concluded (p. 3):

> "We hope, therefore, that the Commission will scrutinize contentions that a general power to recapture give-ups for mutual funds exist. Particularly important is a thorough examination of the rules of the various stock exchanges and of the NASD. If the Commission finds that a power to recapture does exist, we hope that the procedures for such recapture will be spelled out by the Commission with sufficient precision so that they can be followed, where appropriate, by mutual fund managers. Lacking any such

specification at the present time, it is the finding and opinion of the Fidelity Group that give-up recapture abilities to the extent that they exist at all are of limited application and questionable propriety."

The SEC never answered this request for specification.

84. Insofar as it is a question of fact, this court finds that any scheme involving FF's use of its underwriter Crosby as a recipient of a give-up on the understanding that Crosby's parent FMR would give FF a credit against charges for investment advisory services is manifestly a rebate within the meaning of the anti-rebate constitutions and rules of the NYSE and other exchanges. The mere fact that executives of the PBW and Pacific exchanges have acted on a contrary basis does not change that conclusion. Neither PBW's nor Pacific's constitution authorizes its officers to emasculate or destroy by interpretation the anti-rebate rule. And the rule is not so ambiguous as to permit of any interpretation which sustains give-ups to Crosby for the credit of FF, the customer who placed the brokerage orders on which the give-ups were founded.

H. Other Possible Uses of Give-Ups

85. Plaintiff has proposed other possible ways in which give-ups conceivable could have been used for the benefit of the shareholders of FF. None of them is supported by any precedent or authoritative ruling; some are unlawful or contrary to what is deemed fair and ethical dealing; all involve hazards that prudent directors would avoid.

86. For example, plaintiff refers to the possible use of so-called "Aunt Minnies". An "Aunt Minnie" involves a broker, with memberships on both NYSE and a regional exchange, giving up part of his commission on a regional

exchange in consideration of the recipient arranging to place a trade on the NYSE. Thus the recipient pays for the NYSE trade not the regular commission but that amount less the give-up on the regional exchange. This is an unlawful rebate. It has been winked at, but was never approved by the NYSE or the SEC. Moreover the give-up on the regional exchange is unethical because the trader on the regional exchange (the supposititious "Aunt Minnie") does not know about it.

87. Plaintiff's next proposal, unsupported by evidence, is that FMR could use Crosby in the selling group of underwriters. If Crosby were to participate in a selling group and receive an underwriting commission from FF to be credited to FF's benefit it would apparently violate NASD Rules, Art. III. In situations where the underwriting involved a "firm commitment", (where the principal underwriters buy the securities from the seller and sell them to members of the selling group who in turn sell them to the public), Crosby would be violating sec. 17(a)(1) of the Act which makes it unlawful for a registered investment company's principal underwriter "knowingly to sell any security * * to such registered company."

88. Recapture through tender offers would involve Crosby in passing benefits to FF, and that would constitute an "allowance" prohibited by NASD Rules, Art. III, sec. 24.

89. In short, there were not lawful methods for FF getting the benefit of give-ups by Aunt Minnies, or underwritings, or tender offers.

I. Extent to Which Counsel and Unaffiliated Directors of FF Considered Possible Uses of Give-Ups

90. All the directors of FF regularly received at board meetings detailed reports on all aspects of FF's operations,

including placement of brokerage, reciprocals, and give-ups. Included were copies of the so-called N-1R annual reports required by the SEC and transmitted to it. Those reports show FF's primary or leading brokers, the leading recipients of commissions, (including give-ups as well as reciprocals), and the leading sellers of shares. The portfolio manager, Midwood, and the manager of securities transactions, Laufman, frequently appeared before the board to report orally and to answer questions. There were discussions of reciprocals and give-ups and of the system of allocating them on a group basis.

91. All the directors believed that, in the interest of its stockholders, FF should consider as the first and indispensable test in the selection of an FF broker for any transaction his capacity in that transaction to give best execution, and that, the first test being met, FF should select as executing brokers and as give-up recipients those who had sold new shares of the Fidelity group and those who had supplied statistical information. Their common business judgment was that this would promote a net cash inflow to FF and the growth of the fund, which they regarded as beneficial to the shareholders of FF.

92. The directors were aware of the possibility of handling FF's portfolio through a broker affiliate. They regarded such an affiliation as undesirable because it might impede best execution, might stimulate excessive turnover, and might lead to conflicts of interest, or stockholder suspicion of such conflicts. Before this action was brought they did not have knowledge of any other methods of so-called recapture, if indeed any such methods had been actually tried by anyone. They were aware that the preponderant majority of other open-ended mutual funds which did not have captive sales forces followed the same

brokerage, reciprocal, and give-up practices as FF. They recognized, as the SEC did, that unless other similar funds simultaneously changed their reciprocal and give-up practices FF if it changed its practices "would place itself at a disadvantage in competing". [See PPI, Ex. 6, p. 173]. They knew that in its PPI Report of December 2, 1966 the SEC had "given notice that it believes that exchange rules must be changed so as to preclude customer-directed give-ups" [Ex. 6, p. 186]. They, therefore, were not seeking to experiment with untried devices for new uses of give-ups.

93. The directors approved of the statements made in proxy material sent to stockholders and the statements in prospectuses which recited the use made by FF of reciprocals and give-ups. Typical is the following proxy material sent out annually, beginning in 1966, relative to the question of approving continuance of the management contract

> "* * * Dealers with whom the principal underwriter has sales agreements may receive or obtain a portion of the customary and standard brokerage commissions on purchases or sales of portfolio securities not only of the Fund but also of other Funds for which Fidelity Management & Research Company acts as adviser. The Fund may also buy portfolio securities from, or sell such securities to, dealers acting as principals. The Fund always seeks to effect its transactions in portfolio securities whether acting through a dealer as agent or with a dealer as principal where it can get prompt execution of orders at the most favorable prices. While there is no undertaking or agreement to do so, it is the practice of the Fund so far as it is practicably possible, to consider the following additional factors in the allocation of brokerage business:

(1) the relative sales of the shares of all of the Funds for which Fidelity Management & Research Company serves as adviser, and (2) statistical and other factual information provided to the Adviser. These factors are also taken into account where there is no competition among dealers on the basis of price. In no event, however, will these factors be given any weight if this would result in the Fund not obtaining the most favorable price and execution reasonably obtainable.

Allocation as used in the above and the following paragraphs relates to the commissions received by the dealers who execute particular transactions or receipts by a dealer who, althuogh not executing the transaction, receives a portion of the brokerage commission from the dealer who executes the transaction."

94. Plaintiff charges FF's management, particularly Edward C. Johnson 2d, its president, D. George Sullivan, its executive vice president, and Caleb Loring, its general counsel, with having kept the unaffiliated directors ignorant of the possibilities of "recapture" of give-ups, so that the directors were prevented from exercising a business judgment as to courses of action alternative to the use of give-ups to reward and stimulate sellers of fund shares and providers of statistical information.

95. Of course plaintiff's premise is that there were lawful, ethical, and practical alternatives. If the earlier findings are correct plaintiff's premise is wrong, and it would be of no consequence if the officers and counsel of FF failed to inform the unaffiliated directors of the views of those who thought that "recapture" was possible.

96. But even if the earlier findings are mistaken, it cannot rightly be said that the management of FF failed

in keeping the unaffiliated directors informed of available, proven, and legal methods of "recapture".

97. To be sure, Sullivan and those who accompanied him to the June 3, 1965 hearing about the Detroit Stock Exchange did not report to the unaffiliated directors the questions that the SEC staff member Silver put; nor did Sullivan and his companions who attended the September 23, 1966 hearing on Commission Rate Structure report to the directors the questions of staff member Rotberg. But it is hard to fault officers and counsel for not telling directors about questions put by subordinate SEC employees who obviously did not see the technical difficulties with suggestions they informally threw out in the course of an investigatory hearing covering principally other topics.

98. The unaffiliated directors, from press accounts and from discussion at FF board meetings, contemporaneously knew about the Pacific exchange's 1965 admission of broker affiliates of Waddell & Reed and three mutual fund complexes. They promptly received a summary of the SEC December 2, 1966 report called PPI. Some of them saw the text of the report. Loring delivered to their counsel Sumner H. Babcock a copy in the very month it was published.

99. It is also clear that the directors knew about the January 26, 1968 release of the SEC. Their counsel, Babcock, talked with Reilly in between his visits to the regional exchanges and received a copy of Reilly's tentative report a few weeks after it was written. Furthermore, Sullivan gave the directors at the March 28, 1968 meeting a quite accurate statement of just what Reilly's investigation showed was necessary — that is, a statement in writing from regional exchanges as to what each was prepared to

allow by way of recapture in view of the anti-rebate rules [Ex. 3K, p. 2].

100. There is nothing which warrants plaintiff's accusation that "The Management Company, its officers and stockholders consistently kept from the directors any of the information which might have aroused them from their inaction". [Plaintiff's brief after trial, p. 88].

101. The truth is that director McKenzie, who had a lively interest in reciprocals and give-ups, and who was thoroughly familiar with PPI immediately after its publication December 2, 1966, even made proposals to the board of directors of FF which contemplated that Crosby should under some circumstances share the advantages which it derived from give-ups. After discussion, the Board preferred not to share in Crosby's profit but to take into account the advantages of give-ups as part of "the whole package" when FF made its annual contracts with Crosby as underwriter and with FMR as adviser.

J. FF Stockholder Attitudes Toward Reciprocals and Give-Ups

102. The directors of FF never submitted to stockholders of FF for their vote the question of approving FF's use of reciprocals and give-ups.

103. However, these brokerage practices were disclosed to new investors in prospectuses and to stockholders in proxy material submitted in connection with annual management contracts submitted for their approval. Previous findings of fact quoted a disclosure appearing in the 1966 proxy material.

104. When plaintiff became a stockholder in December 1960 she received the prospectus of April 28, 1960. While

it was not as discursive as the 1966 proxy material just mentioned, it put her on notice as to the way FF had handled its brokerage. The relevant language follows:

> "While there is no undertaking or agreement to do so, it is the practice of the Fund, so far as it is practicably possible while seeking the most favorable prices and execution of orders, to place a portion of such business with eligible dealers, using their relative sales of Fund shares as a factor in the allocation. During 1959 approximately one-half of such business was allocated to eligible dealers who had sold shares of the Fund. In some instances, such business was allocated to dealers who provided statistical and other factual information" [Ex. A-1, p. 5].

105. While only the reciprocal and not the give-up practices are spelled out, and no reference is made to the fact that reciprocity is handled on the basis of the combined sales of all publicly-offered funds in the Fidelity group, the 1960 prospectus indicated that FF's brokerage was used in ways that would have a favorable effect on FF's adviser and FF's underwriter.

K. Allocation of Brokerage on the Basis of the Combined Sales of, and Statistical Information Supplied to, All Publicly Offered Funds In the Fidelity Group

106. FF in allocating reciprocal business and in directing give-ups took into account the sales of shares of all publicly offered funds in the Fidelity group, not only the sales of FF shares. FF also took into account statistical information supplied to all members of the FF group, not to FF alone.

107. The directors of FF as a matter of business judgment approved this practice. They did so because they

thought it the only way to avoid undesirable dealer pressure to sell a fund which at a given point in time had large brokerage relative to its sales. They thought it best for the investors if the dealers had a steady uniform interest in all the funds. They were mindful that an investor in one Fidelity fund had the option, without paying a commission or like sales charge, to convert shares he had in one Fidelity fund into another Fidelity fund, and that each year conversions amounting to millions of dollars took place [See Ex. A-13]. They were aware that over a long period of time the benefits of group allocation tend to be equally shared by each participating fund.

108. Group allocation is a common practice among funds competitive with the Fidelity group.

109. It is important to realize that what was being pooled was not the value of give-ups (because FF could not get the give-ups in cash or credit) but merely the value to FF of assigning reciprocals and give-ups.

L. Advisory and Underwriting Contracts

110. In the period now relevant Crosby sold shares of FF pursuant to two contracts with FF: the first is dated December 29, 1961 [Ex. 18-A]; the second, June 1, 1967 [Ex. 18-B]. They are essentially similar.

The 1967 contract [Ex. 18-B] provided:

> "1. The Issuer hereby grants to Crosby the right, during the term of this Agreement and subject to registration requirements of the Securities Act of 1933 as amended (herein called the "1933 Act"), to purchase shares of the Issuer and to resell such shares upon the terms and conditions hereinafter set forth. Crosby shall have the right to purchase from the Issuer as principal at a price equal to the net asset value during

each period determined as described in the current prospectus the shares needed, but no more than the shares needed (except for clerical errors and errors of transmission), to fill unconditional orders for shares of the Issuer received during such period by Crosby from dealers or investors. Crosby shall resell such shares purchased at a price equal to the public offering price determined as described in the current prospectus less, in the case of a sale to a dealer, the discount allowed the dealer, if any."

"2. The net asset value and the public offering price and the decision of whether or not to impose a sales charge upon a public offering of the shares of the Issuer shall be determined by the Issuer. The net asset value and the public offering price shall be computed in accordance with the Rules of Fair Practice of the National Association of Securities Dealers, Inc. and the current prospectus of the Issuer, and Crosby shall be notified promptly thereof. The public offering price (being the price at which Crosby or dealers may sell shares to the public) shall be an amount equal to such net asset value plus a sales charge, if any, varying with the size of the investment as described in the currently effective offering prospectus of the Issuer; and so long as this Agreement remains in effect the sales charge, if any, and the method of determining the net asset value and the public offering price shall not be changed without the written consent of Crosby. The net asset value and the offering price based thereon shall be subject to adjustment in the event of wide fluctuations in market prices, in accordance with the provisions of the Issuer's Articles of Organization, as amended from time to time, and subject to the provisions of the Investment Company Act of 1940 and

state laws regulating the sales of securities, and any regulations of the Securities and Exchange Commission, the National Association of Securities Dealers, Inc. and state blue sky commissioners having jurisdiction. If a sales charge is in effect, Crosby shall have the right to enter into uniform sales agreements with dealers of its choice for the sale of shares of the Issuer and fix therein the portion of the sales charge which may be retained by dealers, provided that the Issuer shall approve the form of the dealer agreement and the dealer discounts set forth therein and shall evidence such approval by filing said form of dealer agreement and amendments thereto as an exhibit to its currently effective registration statement on Form S-5 filed under the 1933 Act."

111. Pursuant to the provision just quoted Crosby entered into uniform sales agreements with dealers [Ex. A-3], setting forth the sales charges and dealer discounts, and providing for payment and delivery of the shares.

112. FF's board of directors approved each of the underwriting contracts.

113. Read together, the underwriting contract, the uniform sales agreement, and the prospectus incorporated by reference show that if he bought from a dealer a purchaser of new FF shares was required to pay the dealer a sales charge of 7½% upon a purchase of less than $25,000 (with a lower percentage for larger amounts). The dealer kept 6%; 1½% was paid by the dealer to Crosby. FF paid no sales charge or commission.

114. The prospectus, which was incorporated by reference, referred to FF's brokerage practices in the very same paragraph that referred to the 6% sales charge the dealer received and to the 1½% that Crosby as underwriter and

distributor received. A typical prospectus for the period covered by this case was dated April 29, 1966 [Ex. 17-B-5] which on pp. 6-7 stated:

> "Dealers with whom the Distributor has sales agreements purchase shares at a maximum discount of 6% from the offering price to investors on transactions of less than $25,000. The balance of the sales charge is retained by the Distributor. The discount from the applicable public offering price is alike for all dealers except that qualified dealers in foreign countries may purchase shares at a maximum discount of 6¾% in return for translating and distributing sales literature in a particular foreign language within a particular country. Dealers may receive or obtain a portion of the customary and standard brokerage commissions on purchases or sales of portfolio securities not only of the Fund but also of other Funds for which Fidelity Management & Research Company acts as adviser. The Fund may also buy portfolio securities from, or sell such securities to, dealers acting as principals. The Fund always seeks to effect its transactions in portfolio securities whether acting through a dealer as agent or with a dealer as principal where it can get prompt execution of orders at the most favorable prices. While there is no formula, or undertaking or agreement to do so, it is the practice of the Fund, so far as it is practicably possible, to consider the following additional factors in the allocation of brokerage business: (1) the relative sales of the shares of all of the Funds for which Fidelity Management & Research Company serves as adviser, and (2) statistical and other factual information provided to the Adviser. These factors are also taken into account where there is no competition among dealers on the basis of price.

In no event, however, will these factors be given any weight if this would result in the Fund not obtaining the most favorable price and execution. The Fund has no intention of placing portfolio business with any particular broker or group of brokers."

115. In approving the contract the unaffiliated directors acted wholly independently of the affiliated directors and at meetings not attended by the latter. Each unaffiliated director was a man of maturity, experience in the world of finance or commerce, reputation extending beyond provincial limits, vigorous mind, and strength of character. None of them was subservient to Edward C. Johnson 2d, or Edward C. Johnson 3d, or D. George Sullivan, or Caleb Loring or anyone else connected with this case. They fully understood the underwriting contracts which they approved. They were aware that the compensation of Crosby (paid by the purchasers of new shares) depended upon the volume of the purchases, that the volume would be increased by rewarding and stimulating dealers who made sales to purchasers, and that the practice (but not the promise) of FF was to furnish stimulants in the form of reciprocals and give-ups.

116. Plaintiff stipulated that she "is not attacking the sales load of the Fund [FF] as excessive" [Ex. 16, par. 6].

117. FF had an advisory contract with FMR at all times during the period now relevant. The 1962 advisory contract between the parties was continued as a result of annual approvals by the already-described independent unaffiliated directors at meetings not attended by the affiliated directors, and then by stockholders to whom was sent proxy material (already quoted in the findings) which expressly referred to FF's brokerage practices and thus informed the stockholder that the brokerage was being used to stimulate

the supply of research to FMR and also to stimulate sales of new shares which, of course, would increase FF's assets which constituted one of the factors in FMR's compensation.

118. Plaintiff stipulated that she "is not attacking the fees paid by Fidelity Fund * * * to the advisor * * * as excessive" [Ex. 16, par. 5].

119. In approving the advisory and underwriting contracts and approving fees thereunder the unaffiliated directors took into account that FMR and Crosby had incidental benefits from FF's methods of handling brokerage and give-ups. While FF did not enter into a bargain with FMR or Crosby to continue FF's brokerage practices, FF directors had these practices in mind in estimating the fairness of the methods used in determining FMR's compensation and Crosby's compensation.

120. At all times there was in effect the following provision in paragraph 12(c) of FF's Agreement of Association:

> "Any [investment advisory or distribution] contract * * * may be entered into with any corporation, firm, trust or association, although one or more of the Board of Directors or officers of this corporation may be an officer, director, trustee, shareholder, or member of such other party to the contract, and no such contract shall be invalidated or rendered voidable by reason of the existence of any such relationship, nor shall any person holding such relationship be liable merely by reason of such relationship for any loss or expense to the corporation under or by reason of said contract or accountable for any profit realized directly or indirectly therefrom, provided that the contract when entered into was reasonable and fair and not inconsistent with the provisions of this paragraph 12."

III

Opinion Incorporating Conclusions of Law.

A. Issues Presented, Jurisdiction, and Burden of Proof.

The introduction preceding the findings of fact recited the four principal questions presented by this action. This formulation has not previously appeared in this case. It represents the court's understanding of the issues both raised by the evidence and canvassed by the parties in their briefs. But it is not wholly responsive to the present state of the pleadings which first, cover much that has been abandoned by stipulation [See Ex. 16], or that has not been supported by testimony or argument, and second, omit specific theories and statutory references which all the parties treat as being before the court.

No doubt, it would be appropriate to allow the parties to amend the pleadings to conform to the evidence. F.R.Civ. Proc. 15(b). The preparation of this opinion could be postponed until the record was in an appropriate posture. However, Rule 15(b) provides that "When issues not raised by the pleadings are tried by express or implied consent of the parties they shall be treated in all respects as if they had been raised in the pleadings."

On that basis, it may fairly be said that plaintiff alleges that she was injured by defendants or some of them having violated

> (a) section 36 of the Act which authorizes the SEC to procure injunctive relief against a registered mutual fund's officers, directors, investment adviser, and principal underwriter if they have "been guilty • • • of

gross misconduct or gross abuse of trust in respect of" a registered investment company,

(b) section 37 of the Act which provides that "Whoever steals, unlawfully abstracts, unlawfully and wilfully converts to his own use or to the use of another, or embezzles any of the moneys, funds, securities, credits, property, or assets of any registered investment company shall be deemed guilty of a crime,"

(c) section 15 of the Act which, *inter alia,* makes it unlawful (1) for an investment adviser, such as FMR, to advise a registered mutual fund except pursuant to a contract in which there is "precisely described all compensation to be paid thereunder" [sec. 15(a) (1) of the Act] and (2) for a principal underwriter, such as Crosby, to sell shares of a registered mutual fund "except pursuant to a written contract" [sec. 15(b) (1) of the Act], and

(d) their general fiduciary duties which she traces to the preamble of the Act, or alternatively to a federal common law which she supposes the federal courts may develop now that Congress has regulated the investment trust business, or alternatively to the law of the Commonwealth of Massachusetts where FF is incorporated.

Insofar as plaintiff alleges that she was injured by violations of sections 15, 36, and 37 of the Act, this court clearly has jurisdiction. *Levitt* v. *Johnson,* 334 F.2d 815, 819 (1st Cir.); *Brown* v. *Bullock,* 294 F.2d 415, 418 (2nd Cir.); Cf. *J. I. Case* v. *Borak,* 377 U.S. 426, 430-431, 84 S.Ct. 1555, 12 L.Ed.2d 423; section 44 of the Act, 15 U.S.C. sec. 80a-43; 28 U.S.C. sec. 1331.

Insofar as plaintiff alleges that she was injured by a violation of fiduciary duties traced to the preamble of the Act, that is section 1 of the Act, 15 U.S.C. sec. 80a-1, she does not assert a substantive claim under the Act or under any of the laws of the United States. See Moore C. J. dissenting in *Brown* v. *Bullock, supra,* 294 F.2d at p. 425. That aspect of her claims fails both on the merits and for want of jurisdiction under 15 U.S.C. sec. 80a-43, or 28 U.S.C. sec. 1331, or otherwise.

Plaintiff's allegation that she was injured by defendants' violations of an uncodified or common law of the United States is not so easily dismissed. It is conceivable that since Congress has regulated the investment trust business, the federal courts may have the power to develop a common law which shall be in accord with the preamble and policy of the Investment Company Act of 1940, which shall fill in the interstices left by Congress, and which shall secure national uniformity. Such a conception would be an extension of the doctrine of *Clearfield Trust Co.* v. *United States,* 318 U.S. 363, 367, 63 S.Ct. 573, 87 L.Ed. 838.

But not every transgression by directors of a registered company necessarily gives rise to a federal claim. *Brown* v. *Bullock, supra,* 294 F.2d, at p. 418. See *Colonial Realty Corporation* v. *Bache & Co.,* 358 F.2d 178, 183 (2nd Cir.). Usually, the mere fact that Congress has regulated an industry does not give federal courts power to shape a federal common law with respect to transactions therein, but instead leaves such transactions to state law. *Pan Am. Petroleum Corp.* v. *Superior Court of Del. In and For New Castle County,* 366 U.S. 656, 663, 81 S.Ct. 1303, 6 L.Ed.2d 584. The usual rule would seem suitable in connection with those alleged breaches of fiduciary duty which arise out of intercorporate transactions and interlocking directorates in

the investment trust industry but which are not within the scope of sections 36, 37. If Congress had wanted to have a federal rule for minor abuses as well as for those grave abuses which are covered by sections 36 and 37, it easily could have so declared. Its silence is negatively pregnant. Moreover, there is little reason, except uniformity, to prefer a federal to a state common law. In this area the state courts have many precedents drawn from a variety of fiduciary and business activities, and reflecting the special gifts of some of the nation's most talented judges.

If it were necessary to decide the issue, this court would reach the conclusion that the claimed federal common law does not exist. A careful reading of *SEC* v. *Aldred Investment Trust*, 151 F.2d 254 (1st Cir.), which has been cited to the contrary, would show that the court there was concerned with violations not of a supposed federal common law, but of section 36 of the Investment Company Act authorizing injunctions against gross abuse of trust. However, it will appear later that the facts in the case at bar do not involve any breach of fiduciary duty even if there is a federal common law governing the actions of these defendants. So, unless an appellate court takes a view of the facts or law different from this court, it is a moot question whether there is a federal common law governing fiduciaries' transactions with mutual funds.

Plaintiff's claims under state law and plaintiff's claims of alleged violations of sections 36 and 37 of the Act "derive from a common nucleus of operative fact" and as such that a plaintiff "would ordinarily be expected to try them all in one judicial proceeding". *United Mine Workers* v. *Gibbs*, 383 U.S. 715, 725, 86 S.Ct. 1130, 1138, 16 L.Ed.2d 218. Therefore this court may exercise pendent jurisdiction over the state claims.

But plaintiff has failed to allege a claim that meets the substantive standard of Massachusetts. Her amended complaint concedes that she has failed to make demand upon the directors or shareholders of FF before she brought this derivative suit. Not having done so, under Massachusetts law she does not state a cause of action in a stockholder's derivative action seeking a remedy for wrongs allegedly done to her corporation. *Palley* v. *Baird*, 1970 Mass.Adv.Sh. 41, 254 N.E.2d 894; *S. Solomont & Sons Trust, Inc.* v. *New England Theatres Operating Co.*, 326 Mass. 99, 114, 93 N.E.2d 241; *Pomerantz* v. *Clark*, 101 F.Supp. 341, 343 (D. Mass.).

Since only federal law is here involved, federal rules with respect to burden of proof govern. Ordinarily where the fairness of transactions between corporations having common directors or between a corporation and its director or officer is challenged, the burden of proof is upon those whose transactions are challenged to show their fairness. *Geddes* v. *Anaconda Copper Mining Co.*, 254 U.S. 590, 599, 41 S.Ct. 209, 65 L.Ed. 425; *Pepper* v. *Litton*, 308 U.S. 295, 306, 60 S.Ct. 238, 84 L.Ed. 281; *Pappas* v. *Moss*, 393 F.2d 865, 867 (3rd Cir.). But in a memorable case, *Ewen* v. *Peoria & E. Ry. Co.*, 78 F.Supp. 312 (S.D.N.Y.), Judge Learned Hand, distinguishing decisions such as *Geddes* on the ground that they "dealt with occasions upon which the fiduciary • • • had not been authorized to deal with his principal", held that "in situations in which the [charter] permitted the directors to deal with the company" the burden of proof is on the beneficiary [78 F.Supp. at p. 317]. He applied his exception to the *Geddes* rule in a case where the New York Central Railroad had entered into an agreement with Peoria to which Central bore a fiduciary relation because it owned a majority of Peoria's stock and dominated Peoria. The agreement gave Central power to allo-

cate traffic, business, and revenues between the two railroads. Investors in Peoria who challenged the allocation made by Central were held to have the burden of proof.

If the *Ewen* case be acceptable doctrine in this circuit it fits this case. But a District Judge, mindful of the conflict in circuits reflected in *Pappas* v. *Moss, supra,* had better see whether in the case before him the matter of burden of proof is moot. Here, as will appear, defendants are entitled to prevail even if the burden of proof on every issue rests upon them. So this court treats the burden of proof question as moot.

It now becomes appropriate to consider each of the four questions presented.

B. The Claim That There Was Not Best Execution.

The first principal substantive issue is whether the defendant directors and the defendant management company (FMR) in placing FF's brokerage on a reciprocal basis violated a statutory or non-statutory duty to secure for the fund the best execution of its purchase and sale orders.

As stated in the findings of fact, defendants have borne the burden of proving that FF achieved, as a matter of regular practice, best execution. This makes it unnecessary to decide whether if directors and managers failed to secure best execution they would have violated sections 36 and 37 of the Act or a federal common law duty.

Whatever law governs, this court must conclude and does conclude as a matter of law that the facts prove that defendants did not violate statutory or non-statutory law by

any failure to secure for the fund the best execution of its purchase and sale orders.

C. The Claim That Give-Ups Could Have Been "Recaptured"

The second issue is whether the defendant directors and the defendant management company in using the give-ups to stimulate sales of fund shares and supply of statistical information violated a statutory or nonstatutory duty to secure for the fund a greater benefit by using the give-ups in some way, such as by directing them to the fund's underwriter, or to a stockbroker affiliated with the fund or its management.

This issue requires a searching inquiry into the nature of customer-directed give-ups and so-called recapture methods. The labels which have been given by the securities industry conceal the critical fact that in reality each is a rebate of the very type that conflicts with the words and the policy of the minimum commission rate and rebate rules which are the cornerstone of every stock exchange constitution.

When in 1792 the New York Stock Exchange was organized a principal object was to maintain a minimum rate structure. [See Ex. 8, "Report of Special Study of Securities Markets of the Securities and Exchange Commission," H.R.Doc.No.95, pt. 2, 88th Cong., 1st Sess. (July 17, 1963) (hereafter called "Special Study"), p. 295]. The founders' avowed purpose was to eliminate competition based solely on price-cutting.

It was not inconsistent with the letter or the spirit of the minimum commission rates and rebate rules to tolerate the ancient and respectable practice of broker-directed give-

ups. [See Ex. 6, "Report of the Securities and Exchange Commission on the Public Policy Implications of Investment Company Growth", H.R.Doc.No.2337, 89th Cong., 2nd Sess. (December 2, 1966) (hereafter called "PPI") p. 169]. When an executing broker directs a give-up to another broker his purpose is to reward him for participating in bringing about the very transaction which earned the commission which is being split. No benefit flows to the customer.

A customer-directed give-up, while verbally similar, has a wholly different purpose and effect. When an executing broker at the direction of his customer gives up part of the commission to another broker who has not participated in the transaction which earned the commission which is being split, the executing broker is surrendering a power of assignment to the customer. Thus the executing broker is giving the customer a rebate. [Cf. Ex. 8, Special Study, Part 2, p. 317, last paragraph and also note 569 which does not appreciate that both the assignor-customer and the assignee-broker are receiving rebates]. Indeed if it were not true that the customer gets by rebate a power of assignment there would be no plausibility to most of plaintiff's complaint which, as her brief stresses, is bottomed on the quite correct assumption that the directors and managers of FF held a power to assign give-ups as a power in trust. [Plaintiff's brief after trial, p. 8 and p. 17A].

No court has yet decided, and this court finds it unnecessary to decide, whether the customer-directed give-ups for the benefit of broker-dealers which were both customary and widely practiced before December 5, 1968 were lawful or unlawful. In any event, a customer-directed give-up which was not used to establish a credit for a customer is

no precedent for a customer-directed give-up which does establish such a credit.

Most of the devices described in parts F and G of the findings of fact (such as an assignment to an affiliate of the customer to form the basis of a credit to the customer), and to which plaintiff and some others give the name "recapture methods", are rebates. They are forbidden by the text and the policy of the minimum commission structure and anti-rebate rules, of which Article XV, section 1 of NYSE (quoted in the findings of fact) is the prototype. Those devices have the evil consequence of giving back to the customer a dollar credit traceable directly or indirectly to the commission he paid.

Inasmuch as an anti-rebate rule is the type of stock exchange rule which has the force of law and is binding alike upon members and customers of the exchange [*Silver* v. *New York Stock Exchange*, 373 U.S. 341, 360-361, 83 S.Ct. 1246, 10 L.Ed.2d 389; *Colonial Realty Corporation* v. *Bache & Co.*, 358 F.2d 178, 181-182 (2nd Cir)] all recapture devices which are contrary to the anti-rebate provisions of exchange constitutions are illegal.

No federal statute and no rule of federal non-statutory law would require directors and managers of a fund to use their fiduciary power to secure for the fund the advantages of illegal recapture devices, or even of devices which are not clearly lawful. A fiduciary is under no duty to engage in legally doubtful experiments virtually unsupported by custom or convention or court decision.

The principle just stated disposes of most, but not all, of the second issue raised in this case. Broker-affiliations remain for consideration.

First, it would be lawful for directors of a mutual fund to contract to have the fund managed and advised by a brokerage concern which did a general business for the public. Such a firm could reduce its advisory charges by brokerage commissions to the extent permitted by NYSE's so-called "Rule 440A".

Second, it would be lawful for the directors of FF and of FMR to agree that FMR should acquire as an affiliate a NYSE stockbroker which was engaged in a general business for the public, and for FMR to credit against the advisory fee charged FF an amount equal to such part of the net profits which FMR derived from the broker-affiliate as were traceable to the brokerage business FF placed with the broker-affiliate.

Third, similar arrangements with a management company other than FMR would be lawful.

Quite apart from whether FF could readily find a broker, or a broker-affiliate, or a management company which wanted to enter into any of the three hypothetical arrangements just suggested (for none of which, except possibly the first, there seems to be any precedent in the business world), the directors of FF long ago determined they did not want FF involved in any situation in which FF's investment adviser and manager would have a stake in, and be intimately intertwined with, a brokerage business.

Such a determination, as the SEC recognized in SEC Exchange Act Release No. 8746 (Ex. A-64), quoted in the findings of fact, is one which directors acting in good faith and rationally are free to make. A bona fide, plausible directors' decision of that kind can not be made the basis of liability of any defendant in this case. *Black* v. *Parker*

Manufacturing Co., 329 Mass. 105, 112-113, 106 N.E.2d 544; *Lincoln Stores* v. *Grant*, 309 Mass. 417, 34 N.E.2d 704; *Shlensky* v. *Wrigley*, 95 Ill.App.2d 173, 237 N.E.2d 776, 779, 781.

From what has been said it follows that this court must conclude, and does conclude as a matter of law, that the defendant directors and the defendant management company in using the give-ups to stimulate sales of fund shares and supply of statistical information made a reasonable business judgment which they were authorized to make and for which they cannot be held liable. They did not violate a statutory or non-statutory duty by failing to use a broker-affiliate, or by not using the give-ups to secure unlawful rebates, or by not using any other imaginary or imaginable untried device which conceivably might have secured for the fund a greater benefit than the benefit (in the form of growth of the fund) which flowed to it from the tolerated use of give-ups to reward and stimulate sellers of Fidelity group shares and providers of statistical information to FMR.

D. The Claim That FF's Assets Were Mingled With Assets of Other Fidelity Group Funds.

The next question is whether the directors and managers of FF in taking into account sales of shares of, and information furnished to, the eleven other funds in the Fidelity group, when they placed FF's brokerage on a reciprocal basis and directed give-ups violated a statutory or non-statutory duty not to mingle the assets of different trusts. Once the facts are understood it is hard to see how it can plausibly be contended that as fiduciaries the directors and managers of FF could be charged with dereliction of duty.

What the directors and managers of FF pooled was not (as plaintiff's brief after trial, p. 70, contends) give-ups and reciprocals. FF did not have, and lawfully could not acquire for itself in cash or credit, the give-ups or any other portion of the commissions it paid to brokers. The anti-rebate rules stood in the way. All that the directors and managers of FF held in trust was the power to assign brokerage commissions and give-ups derived therefrom. The *res* was the mere power of assignment. The power of assignment was limited so that the assignee had to be a member of an exchange or, on some regional exchanges, either an approved non-member of the exchange (Pacific) or an NASD member (Boston, Detroit, PBW). Moreover, the power could not be exercised as payment for anything in the past or in the future with one exception. It was, at best, lawful to assign give-ups as a reward for past sales of shares and past supplies of statistical information and as a stimulus for future sales of shares and future supplies of statistical information. The only advantage to FF from holding this power was to promote cash flow through new sales, growth in the size of the fund, and the acquisition of information by its management company FMR. The monetary value to FF of this power was minimal. It was so insignificant that the SEC and the stock exchanges did not even see its status as a rebate.

More important, the pooling of FF's power of assignment with the powers of assignment held by the other eleven funds far from diminishing its value increases it. So far as concerns statistical information, the powers of assignment were used to encourage supplies of information to FMR. It was to FF's benefit for its adviser to get as much research assistance as possible, and the pooling furthered that result. So far as concerns encouragement of sales of

shares, the advantages of pooling are also clear. What FF wanted was a steady flow of customers for its new shares. FF's need for new shareholders would be at a low point in a period following a period of high sales of FF shares, and at a high point in a period following a period of low sales. It was much better, therefore, not to have too close a correlation between a dealer's most recent performance and the amount of his next receipt of reciprocals and give-ups. Averaging was a far more satisfactory method. The pooling was one way of averaging.

Moreover, the pooling promoted administrative convenience and economy and appealed to dealers who were used to similar practices of other funds and who were the persons whose encouragement was the only possible lawful use of the give-ups. The directors of FF considered those and other advantages and, as a matter of business judgment, favored pooling.

Inasmuch as the pooling was fair to all the funds and furthered the only purposes for which customer-directed give-ups may be lawful, this court concludes that defendants cannot be held liable for adopting that course which they pursued pursuant to a reasonable exercise of business judgment. *Western Pac. R. R. Corp.* v. *Western Pac. R. R. Co.*, 197 F.2d 994 (9th Cir.); *Case* v. *N. Y. Central R. R. Co.*, 15 N.Y.2d 150, 256 N.Y.S.2d 607, 204 N.E.2d 643; *Meyerson* v. *El Paso Natural Gas Co.*, Del. Ch., 246 A.2d 789.

E. The Claim That The Underwriting And Advisory Contracts Violated Section 15 of the Act.

The fourth question presented is whether defendants in omitting from the text of the investment advisory and

underwriting contracts of FF sufficient reference to reciprocal and give-up practices they followed rendered those contracts invalid under section 15 of the Act.

First the underwriting contracts made with Crosby are to be considered.

The quick answer to the attack on that type of contract is that by incorporating the prospectus it does make sufficient reference to "reciprocal" and "give-up" practices. Those names are not used, but the description of FF's brokerage is sufficient to inform the reader that, provided it can get prompt execution of orders at the most favorable prices, FF allocates its brokerage to reward those who sell shares of any of the Fidelity funds and those who supply statistical information to FMR. This is an indication that FF uses its brokerage to stimulate the sales for which Crosby is entitled to charge under the contract.

Quite rightly, the prospectus also says that this brokerage practice is only a practice and that "There is no formula or undertaking or agreement" of FF to maintain such practices. Continuation of that practice was no implied part of the underwriting contract. This became plain when, effective December 5, 1968, the New York and other stock exchanges abolished customer-directed give-ups. The abolition did not result in termination or modification of the underwriting contract.

There being no basis in fact for plaintiff's contention that Crosby was not acting "pursuant to a written contract" when it sold FF shares, this court concludes as a matter of law that plaintiff's claim fails to show any violation of that provision of section 15(b) of the Act which makes it "unlawful for any principal underwriter for a registered open-

end company to * * * sell * * * any security of which such company is the issuer, except pursuant to a written contract".

Next are to be considered the advisory contracts made with FMR.

The contracts admittedly show precisely how FMR's financial compensation is to be calculated. And it has been stipulated that fees paid pursuant to the disclosed formula are not attacked as excessive. What plaintiff claims is that the contracts do not disclose the research information FMR gets as a result of FF's brokerage, and that they do not disclose that FF's brokerage is being used to increase sales of FF's shares and thus to increase FF's assets which constitute one of the factors in determining FMR's compensation.

There are many reasons that the claim must fail.

The research information given by brokers to FMR was not "compensation to be paid" [See section 15(a) (1) of the Act] by anyone to FMR. At most FMR was an incidental beneficiary of arrangements between the brokers and FF. The information was given to FMR for FF's benefit not with the purpose of benefitting or compensating FMR. FMR had no legal right to demand such research information. Neither FF nor the brokers had a legal duty to supply it to FMR. When give-ups were discontinued after December 5, 1968, no one supposed that an implied condition of the advisory contract had been broken and that FMR's fee had to be adjusted accordingly.

Insofar as plaintiff contends that the advisory contracts should have shown how brokerage might affect the total

fees received by FMR, she is clutching at straws. The contract discloses the precise formula upon which FF is to pay FMR. The formula being clear it is unnecessary, and indeed probably impossible, to list or describe how the impact of that formula may be affected by each of the activities of the parties. For example, FF surely would be imprudent if it tried to predict how much its assets would be increased in the next year by the sale of new FF shares stimulated by FF brokerage practices. FF in advance cannot even guess how eager persons will be to buy shares in mutual funds in the next year, or how much brokerage FF will have, or how much of that brokerage will go to the third market on the principle of best execution. Hence reference to brokerage practices would not add precision to the already revealed basis on which FMR is to be compensated.

Moreover, it is plain that FF did not try to hide the benefits FMR got from brokerage. The proxy material, already quoted, tells the story adequately.

Upon the basis of the facts found, this court's conclusion of law is that defendants FMR did not violate the provision of section 15(a) (1) of the Act making it "unlawful for any person to serve or act as investment adviser of a registered company, except pursuant to a written contract, which contract * * * (1) precisely described all compensation to be paid thereunder."

F. The Claim That Johnson 2d, Johnson 3d, FMR and Crosby Hold Their Profits Upon a Constructive Trust for FF.

Plaintiff claims that Edward C. Johnson and his son as directors of FF, FMR as its adviser, and Crosby as its

underwriter, were all in violation of their fiduciary duties when they caused FF to place its brokerage on a reciprocal basis and to direct give-ups to brokers who had sold Fidelity fund shares and who had supplied FMR with research information, and that the profits the two directors and the two companies derived from so placing brokerage and directing give-ups were held upon a constructive trust for FF.

Plaintiff relies upon the principle stated in Restatement, Restitution sec. 190:

> "Where a person in a fiduciary relation to another acquires property, and the acquisition or retention of the property is in violation of his duty as fiduciary, he holds it upon a constructive trust for the other."

Reference is also made to Restatement, Restitution secs. 1, comment (c), 138, and 197, Restatement, Agency secs. 387, 388, and 404A, Restatement, Trusts 2d secs. 170, 203, 205 and 206, 2 Scott on Trusts (3rd ed.) sec. 170.22.

To this claim the complete answer is that none of the named defendants acted in violation of his or its duty. Their obligation was to place the brokerage so as to secure best execution and to get for FF what lawfully could be derived from the give-ups for the benefit of FF. It was not their duty to adopt unlawful recapture or rebate methods. It was not their duty to cause FF to place its business with a broker adviser or broker affiliate inasmuch as that was contrary to the business judgment of FF's directors.

Furthermore, the advantages which Crosby and FMR and the Johnsons as stockholders of FMR derived from the way FF placed its brokerage were taken into account when

FF entered into its advisory and underwriting contracts, and were the consequence of procedures disclosed to shareholders in prospectuses and proxy material. This is not the case of a profit derived by a fiduciary who commits a breach of trust. It is the case of an incidental benefit which comes to fiduciaries without the violation of any obligation, but rather as a consequence of contracts lawfully made between the beneficiary and the fiduciaries.

Amended Complaint dismissed on the merits.

JUDGMENT

(CAPTION OMITTED)

AMENDED JUDGMENT
August 27, 1970

WYZANSKI, C. J.

Pursuant to plaintiff's motion to amend judgment, and upon its allowance thereof, it is hereby ORDERED, final judgment dated August 18, 1970 is vacated, and it is further ORDERED, ADJUDGED, and DECREED that the complaint is dismissed as to all the defendants, corporate and individual, with prejudice, and without costs.

s/CHARLES E. WYZANSKI, JR.
Chief Judge, United States District Court

APPENDIX B

Opinion, Judgment and Amendment of Opinion of the United States Court of Appeals for the First Circuit

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ROSE MOSES

v.

C. RODGERS BURGIN et al.

No. 7745

June 4, 1971

——— F.2d ———

Aldrich, *Chief Judge.* Plaintiff Moses, a shareholder of Fidelity Fund, Inc. (Fund), a Massachusetts-incorporated investment company, in December 1967 filed a complaint, and in November 1968 an amended complaint, in this derivative action. Fund is an open-end mutual fund, registered under the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 et seq. Defendants, in addition to Fund, are Fidelity Management and Research Company (Management), Fund's investment adviser; The Crosby Corporation (Crosby), a wholly owned subsidiary of Management and sometimes included within that term, an underwriter whose sole business is selling shares of Fund to independent broker-dealers; E. C. Johnson 2d, president and director of Fund, and president, director and principal voting stockholder of Management; E. C. Johnson 3d, director of Fund

since April 1968, and director and substantial voting stockholder of Management; and C. R. Burgin, G. R. Harding, G. H. Hood, Jr., R. Jones, G. K. McKenzie and H. Schermerhorn, who are or were directors of Fund who claim not to be "affiliated" within the meaning of section 10(a) of the Act, 15 U.S.C. § 80a-10(a), hereinafter the unaffiliated directors.[1] Although the last two were named as defendants, the action has been dismissed against them for lack of service of process. Other dramatis personae, not defendants, include D. G. Sullivan, a vice-president of Management and Fund and since April 1968 a director of Fund; C. Loring, Jr., an officer of Fund and counsel for, and a non-voting stockholder of, Management; and S. H. Babcock, retained in December 1966 as counsel to advise the unaffiliated directors.

Plaintiff complained of various breaches of fiduciary duty allegedly imposed by the Investment Company Act and the common law. Following an extensive trial on liability only, the district court resolved all ultimate issues against her. 316 F.Supp. 31. Plaintiff appeals. The record is voluminous, the briefs lengthy and detailed, and the sums of money involved substantial. Many of the claims advanced in the district court are no longer pressed. Before us plaintiff makes one principal complaint, that Fund could, and should, have recovered a portion of the brokerage commissions it was obliged to pay on its so-called portfolio business, viz., on the purchases and sales of the securities in which it invested its assets. Plaintiff's proposals as to how this should have been accomplished require a considerable review of Fund's method of operation.

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[1] Plaintiff has not successfully attacked the court's finding (F. 115) that these defendants were legally unaffiliated and factually independent. Whether, in some measure, they abdicated their responsibilities we will consider later.

Fund's shareholders are numbered in five, and its assets in the upper nine, figures. The amount of its assets, apart from changes in the market value of its investments, depends upon the number of shares that it can sell as against the number it must redeem. Both activities are continual. The purchasers of individual participating interests, or shares, pay their net worth in terms of the current value of Fund's assets, plus a 1½% sales charge to Crosby and a brokerage commission of 6%.[2] In response to advice by Management, Fund is constantly changing its portfolio. This is done through independent broker-dealers, and mostly involves trading by them on the New York and regional stock exchanges. The conclusion of a trade is commonly referred to as execution. A claim made in the district court was that defendants, in choosing their brokers, or other trading methods not presently pertinent, did not always obtain best execution. The court resolved this issue against plaintiff, from which no appeal is taken.

The exchanges, at all relevant times, set required commission rates, with no quantity discounts. Because of the size of many mutual fund transactions brokers competing for business were willing to give up a portion of the commissions they received from the fund. "Anti-rebate" rules adopted by every exchange prevented any rebate or discount, direct or indirect, that would bring the net commission paid below the minimum level set by the exchange. As will be described, the total effect of these rules was in doubt, but they at least prevented direct cash refunds to the customer. On Fund's instructions, at Management's behest, the so-called customer-directed give-ups were paid over to brokers who sold shares of Fund acquired from

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[2] There are quantity discounts in these charges, a matter not presently relevant.

Crosby to the public, in proportion to their success, in order to stimulate sales.[3] Customer-directed give-ups are to be distinguished from broker-directed give-ups, a long-recognized practice whereby two or more brokers who have shared in the work divide the commission between themselves. Give-ups which are customer-directed (which is what we shall mean by the term "give-up" hereafter) are inherently and necessarily, as the district court found, in the nature of a refund, or rebate to the customer.[4]

Plaintiff's complaint is double-barreled. First, she complains of Fund's give-up practices because they resulted in the loss of the value of brokerage commissions which could have been recaptured. She claims recapture was possible either by creation of a broker affiliate that could participate in Fund portfolio transactions, or by channeling present give-ups to an affiliate, with the result that in either case the sums involved would be credited to Fund. Second, she complains that the give-up practices, pursued to the exclusion of either course she suggests, benefitted Management and Crosby, since stimulating sales of Fund's shares increased Crosby's commissions, and increased Management's advisory fee, which was measured by the size of Fund's portfolio. Accordingly, plaintiff claims that Management and the two Johnsons, who together owned 90% of its voting stock, were using Fund's assets to their own private advantage. More pointedly, she claims in particular that Fund's board never considered these possibilities because relevant information regarding them was improperly withheld from the unaffiliated directors by the Manage-

[3] To a lesser extent give-ups were also used to reward brokers who supplied statistical information to Management for use in making investment decisions.

[4] "When an executing broker at the direction of his customer gives up part of the commission to another broker who has not participated in the transaction . . . . the executing broker is giving the customer a rebate."

ment defendants.[5] Recovery is sought, inter alia, under section 36 of the Investment Company Act, 15 U.S.C. § 80a-35. To prevail on this appeal plaintiff must persuade us that the district court's rulings were wrong and that its factual findings in defendants' favor were clearly erroneous. Plaintiff openly accepts this burden.[6]

Jurisdiction

Before coming to the merits we consider briefly the district court's jurisdiction. Defendants contest vigorously plaintiff's claim that the Investment Company Act establishes a general federal common law of fiduciary obligation, or that she has a valid claim, by way of pendent jurisdiction, under Massachusetts corporate law. We reach neither of these questions, since we see no way in which they would

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[5] Plaintiff also complains of the use of "reciprocals," a pratcice by which Fund, at Management's direction, awarded some of its portfolio business to particular brokers in proportion to their success in selling Fund shares to the public. On the district court's unexcepted-to findings that the execution of Fund's portfolio business was always satisfactory we do not see how reciprocals are involved on this appeal. Whereas furthering sales of its own shares may not have warranted an expense to Fund, reciprocals, as such, cost it nothing. We see no reason to reject the SEC's conclusion that awarding reciprocals even to brokers who have done nothing to benefit the funds is unobjectionable if it "does not in any way operate as a detriment to the funds and if the funds have themselves derived as much as they can from these benefits." Securities & Exchange Comm'n, Report of Special Study of Securities Markets, H. R. Doc. No. 95, 88th Cong., 1st Sess. pt. 4 at 214. This is not to say that granting reciprocals in some particular instance may not conflict with the duty to recapture. See post.

[6] We are urged at length by defendants, in common with most appellees who come before us with findings in their favor, that we have no power to review the evidence de novo. We recognize this, and strive not to do so. This is not to say, however, that we cannot reverse findings which are unsupported by the evidence, or which are so contrary to the great weight of the evidence as to compel the conclusion that a manifest error has been done, and in such circumstances make the opposite finding. Nor does it mean, where no finding has been made at all, that we cannot make our own finding, provided that the great weight of the evidence would compel such a conclusion.

change the result. Defendants do not seriously dispute that the Act impliedly authorizes the courts to grant civil recovery if their conduct fell within the scope of the phrase "gross misconduct or gross abuse of trust" contained in section 36 of the Act, 15 U.S.C. § 80a-35.[7] We agree with the district court that we have jurisdiction at least to that extent. *Brown* v. *Bullock,* S.D.N.Y., 1961, 194 F.Supp. 207, 245, *aff'd* under other sections, 294 F.2d 415; *cf. J. I. Case Co.* v. *Borak,* 1964, 377 U. S. 426, 430-33.

Case relied on a general grant of jurisdiction to "enforce any liability or duty created by" the act in question, a provision identically repeated in section 44 of the Investment Company Act, § 80a-43. Further, it is apparent that the purpose underlying section 36 included protection of shareholders against self-dealing by the managers. *See* section 80a 1(b), quoted post. This can best be accomplished if recourse to the courts is available to private parties who have been thus wronged, as well as to the SEC. *See* Note, The Mutual Fund and Its Management Company, 71 Yale L. J. 137, 152 and nn. 74-75 (1961) (SEC requests private rights of action for effective enforcement of the Act). Our finding of a private right of action is in accord with the majority of the courts that have reached this question. *See Esplin* v. *Hirschi,* 10 Cir., 1968, 402 F.2d 94, 103, *cert. denied,* 394 U.S. 928 (concerning the Investment Company Act in general); *Brown* v. *Eastern States Corp.,* 4 Cir., 1950, 181 F.2d 26, *cert. denied,* 340 U.S. 864 (also concerning the Act in general) (by implication); *Tanzer* v. *Huffines,* D.Del., 1970, 314 F.Supp. 189, 193; *Brown* v. *Bullock* (district court opinion), ante. *But see Brouk* v. *Managed Funds, Inc.,* 8 Cir., 1961, 286 F.2d 901, dismissed, 369 U.S. 424, *with*

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[7] This section has since been amended, 84 Stat. 1413 (1970), 39 U.S.L.W. 93, 98, in part to make explicit certain private rights of action.

which compare Greater Iowa Corp. v. *McLendon,* 8 Cir., 1967, 378 F.2d 783, 789-90.

The Duty To Recapture

The brief filed on behalf of Management, Crosby and the two Johnsons states,

> "The court found that it was the directors' common business judgment that encouraging sales would promote a net cash inflow and growth of the Fund beneficial to the shareholders."

Calling this a "policy decision to promote sales" the brief added that the court found that the directors believed that Fund's awards of give-ups to brokers who sold its shares to the public enhanced its sales. Management's implication,[8] which in oral argument it emphasized to the point of affirmation, was that, if recapture was in fact practical, the directors still had a right to choose between recapture of the give-ups for Fund's direct benefit, and awarding them to brokers for its indirect benefit. We hold, however, that if recovery was freely available to Fund, the directors had no such choice.

Fund's charter required that upon sale of its shares it receive their full asset value. The obvious purpose was to prevent the value of the existing shareholders' interest in the assets from being diminished by the addition of further participants. If Fund receives the asset value of new shares, but at the same time rewards the selling broker with give-ups that it has a right to recapture for itself, then the net income Fund receives from the process of selling a share is less than asset value. The existing share-

[8] As, for example, by the reference in Management's brief to "a community, rather than a conflict, of interest in sale of Fund shares." The conflict, of course, was who was to pay for it.

holders have contributed — by paying more than otherwise necessary on Fund's portfolio transactions — to the cost of the sale, which was supposed to have been borne by the new member alone. We cannot, therefore, consider absolving the defendants, if we find that they have violated any duty owed the Fund, by finding that directing give-ups to brokers benefitted Fund by stimulating sales of its shares. Such application violated its charter if it would have been practicable to obtain the give-ups for the direct benefit of its treasury.

Management counsel ultimately conceded this during oral argument. We have dwelt upon it to show that the concession was correct. This is not, of course, to say that the court was not justified in finding that it was beneficial to existing shareholders to promote sales of Fund's shares, as well as being beneficial to Management and to Crosby. It is merely that, by the terms of the charter, Fund cannot use free money, or credit, to pay brokers for sales. Sales are Crosby's business. Whether, during the period covered by the complaint, it was practical for Fund to recover commissions for its direct use is another matter.

Broker Affiliation

There are a number of methods of mutual fund operation. In general, as has been pointed out, management is placed in the hands of an independent entity. Beyond that, some funds sell their participating shares through a captive sales force and others, including Fund, through independent brokers. Some conduct their portfolio business through the same entity that furnishes them with investment advice, while many, like Fund, use independent brokers. There are basic, fundamental differences in the operational problems, and risks to the fund, resulting from the use of affiliated, versus independent, brokers for portfolio transactions.

Some of these are dealt with in detail in the district court's comprehensive opinion. We see no purpose in further elaboration. Suffice it to say that a change from independent brokerage to an affiliated broker is not a matter to be lightly undertaken.

It is in this vein that we must see plaintiff's contention that Fund should have decided to have an affiliated broker since recapture could have been effected by having Crosby, or some new subsidiary of Management, become a broker member of an exchange. Plaintiff puts this point with something less than full clarity. Insofar as a fund has a broker affiliate which acts as its executing broker, no question of give-ups arises at all; the issue is the possibility of recapture of the affiliate's profits. It is true that if the broker-affiliate was not used as the fund's exclusive trader, there would in addition be the possibility of using the affiliate to recover give-ups resulting from trading through other houses, and recapturing these as well. It is only too clear, as the court found, that the unaffiliated directors had noted the general risks attendant upon a brokerage operation, especially the risk of loss of best execution, and they had long decided against it. The court found, on adequate evidence, that there were sound business reasons for this decision. We agree; the directors had no duty to pursue plaintiff's suggested course of action, and without their doing so, recapture was not freely available. Plaintiff knew of Fund's practice when she bought her shares; she could have chosen a fund that did have an affiliated broker.

While the court found that the unaffiliated directors learned, in 1965, of the Pacific exchange's admission of broker-affiliates and had in fact rejected such an operation, there is evidence that some of them did not consider, when deciding, the full possibility of thereby recapturing the

broker's profits and give-ups accruing from trading with other houses. The court did not specifically address itself to that question. We cannot find in the evidence, however, any reason to suppose that this difference would have swung the balance in the other direction.[9] Plaintiff has not met her burden of showing the court plainly wrong.

Alternatively, plaintiff suggests that Crosby might have become a more limited type of broker, on the New York Stock Exchange, known as an introducing broker. This itself would not have required substantial operational changes, in fact, plaintiff's suggestion is really that Crosby could become, under this label, a conduit for give-ups though not in any way engaged in normal brokerage activities. But the court found that NYSE required that all brokers, to be members, must be engaged primarily in brokerage, and that in the application of this principle the exchange regarded the broker and its affiliates as one. It found that Management and Crosby, accordingly, would not have been able to qualify for membership. (F. 56). Plaintiff has not successfully attacked this finding.

NASD Recapture

We turn, accordingly, to plaintiff's second major claim, that without the necessity of a broker affiliate, or changing Crosby's methods of operations, give-ups could have been channeled to Crosby — already eligible to receive them — to be applied against Management's advisory fee, a process that has been described as indirect recapture.

Six of the seven regional exchanges permitted members of the National Association of Securities Dealers (NASD)

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[9] Two unaffiliated directors testified that they did know of this factor; none testified that they would have decided differently had they considered the matter in those terms. See, further, the account of the December 14, 1966 Fund directors' meeting, post.

who were not exchange members, either by joining the exchange as special members, or even without the formality of any membership, to receive customer-directed give-ups.[10] Crosby was a member of NASD. Plaintiff asserts that Crosby, without making any changes in its structure or any basic commitments, was or could have become qualified to receive give-ups on these exchanges, and that Fund could have directed such receipts, having agreed with Management to set them off against its advisory fee.[11] Management responds that if Fund had so directed, Crosby's crediting Fund would have violated the anti-rebate rules of the exchanges, and hence would not have been permitted. To this plaintiff replies that by 1965 the Pacific Exchange was allowing funds to recapture brokerage commissions from their broker-affiliates via setoffs against advisory fees owed to management, and that there was no reason to expect that it would draw a distinction, under its anti-rebate rule, against similar recapture of commissions funnelled from independent brokers to NASD members connected with Fund; that Management failed to investigate, or even to inform the unaffiliated directors of the possibility of this indirect recapture; that in 1967 the Philadelphia-Baltimore-Washington Exchange (PBW) did permit a fund to recapture its give-ups through NASD membership of its

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[10] Securities and Exchange Comm'n, Public Policy Implications of Investment Company Growth, H.R.Rep. No. 2337, 89th Cong., 2d Sess. 171 (1966), discussed post.

[11] Indeed, since Crosby would have done nothing to earn them, under section 17(e) of the Act, 15 U.S.C. § 30a-17(e), Management could not lawfully have kept such money. Furthermore, under familiar fiduciary principles, Management would have been obliged to credit Crosby's receipts, as, for example, against Fund's contractual obligation to pay its advisory fee. *Barney* v. *Saunders*, 1853, 57 U.S. (16 How.) 535, 543; *Matter of Provident Management Corp.*, SEC 12/1/70, CCH Fed. SEC L. Rep. ¶ 77,937. It may be noted that these authorities require accounting even if the fiduciary's receipt was illegal.

adviser-underwriters; and that in 1968, when Management finally pursued this subject, a second exchange, Pacific, agreed to essentially this procedure. The balance of this opinion deals with this subject.

Management's Duty of Disclosure

Plaintiff's argument criticizing the Management defendants for not effecting NASD recapture is based on her finding implicit in the Investment Company Act the familiar general principles governing fiduciaries in the area of self-dealing. We do not denigrate these principles, though we need hold relevant only their expression through the federally imposed standard under section 36, which may vary from the state common law. We believe, however, that the Act imposes a more fundamental and pervasive requirement where, because of the structure of investment trusts, self-dealing is not the exception but, so far as management is concerned, the order of the day. One of the primary reasons for Congress' enactment of the Investment Company Act was its finding that,

> "the national public interest and the interest of investors are adversely affected . . . (2) when investment companies are organized, operated, managed . . . in the interest of directors, officers, investment advisers . . . underwriters . . . rather than in the interest of all classes of such companies' security holders . . . ." 15 U.S.C. § 80a-1(b).

Unlike an ordinary trust, or a business, management's normal activities are frequently touched with self-interest, as the example of give-ups, universally used, and benefitting management at least as much as fund shareholders, clearly shows. Management defendants admit that they gained from the give-up practice, while asserting that Fund also

benefitted from the resulting growth.[12] To the extent that they, or the court in finding for them without finding full disclosure, imply that their self-interest could not influence the decisions to be made on behalf of Fund, Congress had an answer. It responded to this problem by enacting a mandatory provision for unaffiliated, that is, independent, watch-dog directors. 15 U.S.C. § 80a-10(a).

Whatever may be the duty of disclosure owed to ordinary corporate directors, we think the conclusion unavoidable that Management defendants were under a duty of full disclosure of information to these unaffiliated directors in every area where there was even a possible conflict of interest between their interests and the interests of the fund. This duty could not be put more clearly than was stated by the SEC in 1965.

> "The Investment Company Act's requirement as to unaffiliated directors, if its purposes are not to be subverted, carries with it the obligation on the part of the affiliated directors, and the investment adviser itself, to insure that unaffiliated directors are furnished with sufficient information so as to enable them to participate effectively in the management of the investment company." *Imperial Financial Services, Inc.*, CCH Fed. Sec. L. Rep. ¶ 77,287 at 82,464 (SEC 1965).

Except where it may be fairly assumed that every unaffiliated director will have such knowledge, effective communication is called for. And, in testing that assumption, it must be borne in mind that they are not full time employees of the fund and it may be — as with Fund's unaffiliated directors — that neither their activities nor their experience are primarily connected with the special and often technical problems of fund operation. If management does not keep

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[12] *See* n. 8, ante.

these directors informed they will not be in a position to exercise the independent judgment that Congress clearly intended. The only question can be whether the matter is one that could be thought to be of possible significance.

Management's Failure To Disclose

The district court found untrue plaintiff's claim that Management "consistently kept from the directors any of the information which might have aroused them from their inaction." (F. 100) This finding is supportable only in the sense that the concealment was not "consistent." In any other sense it is plainly erroneous as to NASD recapture in the light of the knowledge Management concededly possessed which could well have aroused the unaffiliated directors. As will be developed, the inescapable fact is that Management defendants did, for an extended period of time, keep to themselves possibly, we would say probably, stimulating information.

In June 1965, two representatives of the SEC, Silver and Eisenberg, conducted an inquiry of Fund representatives, trading on the Detroit Stock Exchange and Off-Board Trading by Exchange Members. Sullivan, together with Hamilton, another officer of Management, and Belash, a law partner of Loring, attended. In the course of the proceedings Silver suggested that Crosby, though not an exchange member, could receive give-ups through its NASD membership which could then be set off against the advisory fee. Hamilton responded that directing any give-ups to Crosby would conflict with Illinois blue-sky laws, thus affecting Fund's sales there. Silver replied that the Illinois rule was obviously designed to prevent underwriters from benefitting at the expense of the fund, and asked whether Illinois would object if the give-ups were applied to credit Fund.

Sullivan, in disregard of the charter obligation not to use money or credits that were available to Fund to support sales of its shares, stated that the change would irritate dealers who had been receiving give-ups and have a consequent bad effect upon sales. Silver inquired whether the need to compete with the funds that had joined the Pacific exchange, and were reducing brokerage commissions that way, might change their view of the economics of the situation, which we interpret as a suggestion that Fund's asset loss of recapturable give-ups might have a more adverse effect on sales than would the loss of rewards for dealers. The SEC had already indicated in its 1963 Special Study, n.5, ante, that the principal beneficiaries of fund-paid portfolio commissions are not the funds, but the advisers and underwriters. What was new was the suggestion of how, in fact, the interests of Fund could be better served. The suggestion by Silver should clearly have imparted to Management the idea that its benefit could not conflict with Fund's interest — and should, in turn, have made these defendants sensitive to the need for passing the suggestion along to the unaffiliated directors. However, as the court found, this was not done. Nor was anything else done.

In September 1966, three SEC representatives, Rotberg (Rothberg?), Eisenberg and Archie conducted further SEC inquiries, this time entitled Commission Rate Structure. The same Management representatives attended. There was a general discussion of NASD recapture of give-ups.[13] Rotberg suggested, inter alia, that Fund should recapture through Crosby. Sullivan and Belash again mentioned the

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[13] Management defendants seek to suggest that the 1965 SEC proceedings, having Detroit in their title, raised no questions applicable or relevant to any other exchange. We do not think, in the light of the content, that it was reasonable for Management to see no broader implication in the discussion recounted above. In any event, no argument can be made that the 1966 questioning was so restricted.

depressing effect upon sales. It was added that such conduct would conflict with Crosby's contract, and it was again stated that it raised problems under Illinois blue-sky laws. Rotberg pointedly asked what Fund had done since the staff's same suggestions had been made at the previous proceeding. The Fund representatives replied, "Nothing," explicitly adhering to the position that Fund needed the friendship of the small brokers more than it needed the money. No one suggested the possible illegality of recapture under the anti-rebate rules upon which all defendants now rely.[14]

Again, although by this time the conflict was clearly laid out, the court found that nothing was reported by the Management defendants to the unaffiliated directors. In their brief the Management defendants say, seemingly to imply that no communication was necessary, that they "investigated the substance of these questions," and concluded that nothing could be done. "Investigation" seems a palpable exaggeration of what was done. All the record shows is that they discussed it among themselves.

In sum, we can only conclude that the Management defendants saw a question, that they knew it to be in an area where there was a conflict between their personal interests and the direct interests of the Fund treasury, and that they did not inform the unaffiliated directors or submit it to their consideration.

Nor was this all. On December 2, 1966 the House Committee on Interstate and Foreign Commerce released an SEC report entitled Public Policy Implications of Invest-

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[14] We flag this matter in anticipation of a later reference, because Management defendants, in attempting in their brief to minimize the SEC assertions that recapture was possible, state that the staff suggestions "indicate . . . unawareness of the anti-rebate rules." If so, the Management representatives, in whose court the ball was, were equally myopic.

ment Company Growth (PPI); H.R.Rep. No. 2337, 89th Cong., 2d Sess. (1966). At page 173, in a subsection entitled, "Reducing advisory fees," it was stated,

> "It would not be inconsistent with those rules for dealer-distributed funds to direct give-ups to their adviser-underwriters, all of whom are NASD members, for the purpose of applying these give-ups to reduce the advisory fees payable by the funds."

Loring, Johnson 2d, and Sullivan discussed this among themselves, but did nothing further. While the Management defendants now claim that they communicated this information to the unaffiliated directors, they face insuperable obstacles to establishing that assertion. In the first place, the court made the following general finding.

> "Before this action was brought [the unaffiliated directors] did not have knowledge of any other methods of so-called recapture [than through a broker-affiliate.]"[15] (F. 92)

We cannot believe that the court meant by this finding that it believed that the unaffiliated directors were given the information, but forgot about it. Nor are Management defendants helped by the evidence they cite to support their claim. They list four matters.

a) That McKenzie, on his own, obtained and read a copy of the PPI report. Even if this can be taken to mean that McKenzie noted and understood the meaning of the two relevant pages in this 346 page report, McKenzie was only one of five unaffiliated directors.

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[15] This finding is not contradicted by the finding (F. 96) that Management did not fail to keep the unaffiliated directors informed of "available, proven and legal methods of recapture." That finding must be read in the light of the court's earlier conclusion that NASD recapture, even if not unlawful (which it said it was), was at least unproven and of doubtful legality.

b) That, as the district court found, a copy of the report was given by Loring to Babcock. There is no evidence, however, that the matter of NASD recapture was called to his attention. Babcock did not take the stand. No unaffiliated director testified to any communication with him at that time on the subject of recapture, and there was no evidence to indicate that his retainer included consideration of the possibility of, or the duty to, recapture until his opinion was asked in August 1968.

c) That, as the court found, a summary of the report, prepared by the SEC, was given to all of the unaffiliated directors. The summary, however, did not refer to the portion of the report dealing with NASD recapture.[16]

d) That McKenzie testified that following the issuance of the report, he discussed recovery of give-ups at the December 14, 1966 meeting. The minutes of the meeting state, "Excerpts from the [PPI report] was read, including the factors to be considered in determining the reasonableness of management fees." Determining management fees is the subject of Chapter III, "The Management Function and Its Cost," which occupies some 70 pages of the report. "Reducing advisory fees" by credits through NASD recap-

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[16] A defendants' exhibit shows that two summaries were given to the directors. One was a release by the SEC. The other, a mimeographed pamphlet, does not disclose its authorship. The former, without suggesting the alternative, stated that use of "brokerage" — meaning give-ups — to reward sales had a potentially bad effect upon best execution, and encouraged brokers to sell shares of the mutual fund which paid them the most, regardless of its quality. The mimeo mentioned give-ups in terms, but limited itself to stating that the SEC believed that the exchanges should abolish them in favor of volume discounts.

The Management brief states that "[t]he plaintiff's complaint that this summary 'contained not a word about recapture' (Pl. Br. 34) should be directed to the SEC . . . ." Whatever merit there may be in this remark, and we see none, it certainly cannot justify Management's reference to the summary as support for its position that it informed the unaffiliated directors of the PPI position on recapture.

ture is a short subsection in another chapter. It was never mentioned. Examination of McKenzie's testimony, including all references made in Management's brief, clearly reveals that he was talking about fixing the advisory fee and giving some consideration in connection therewith to recapture through West Coast broker affiliation, the method we have already dealt with.[17] The district court, likewise, did not accept it as showing that NASD recapture was discussed or it would not have made the general finding, previously adverted to, that the unaffiliated directors had no ante litem knowledge of this method of recapture.

On the basis of the above, Management's brief makes the bald statement, "[B]oth the [PPI] report itself and, in particular, the relevant passage, captioned 'Reducing advisory fees' . . . were put before the board." How they could say this, passes our understanding.

Post Litem

With the commencement of this suit in December 1967, a year after the PPI report, the matter of recapture of give-ups was sharply brought to the unaffiliated directors' attention. The suit was followed shortly by Securities Exchange Act of 1934 Release No. 8239, dated January 26, 1968, proposing a new rule, 10b-10. In its introductory portion the release stated that the purpose of the proposed rule was to "prohibit investment company managers from directing brokers executing transactions for an investment company to divide their compensation in any way with other brokers unless the benefits of such division accrue to the investment company and its shareholders." It stated that the rule "had its antecedents" in the PPI report, citing

[17] At one point there was a McKenzie Plan. It was rejected. We find it of no present relevance.

specifically the sentence at page 173 which we have quoted ante, and added, "The reasoning on which the proposed rule is based is that if, as pointed out above, a mutual fund manager has various means at his disposal to recapture for the benefit of the fund a portion of the commissions paid by the fund, he is under a fiduciary duty to do so."

The presently relevant portion of the rule is the first subsection.

> "Rule 10b-10
>
> "(1) It shall be unlawful for any registered investment company or affiliated person of such registered investment company to directly or indirectly, to [sic] order or request any broker or dealer:
>
> "(a) to pay or arrange for the payment, directly or indirectly, of all or any portion of a commission on any securities transaction to any broker, dealer or any other person *unless* pursuant to a written contract the full amount of such remittance is required to be paid over to such registered investment company, or fees owed by or charged to such registered investment company are required to be reduced in an amount equal to the remittance; . . ."

The directors, shown the release by Sullivan on February 5, 1968, appointed Sullivan and Loring, both of whom, it will be recalled, represented Management, to advise them what they should do. They, in turn, designated Belash and Reilly of Loring's law firm to investigate the practices and possibilities of recapture on various regional exchanges. Reilly's resulting report was submitted to Sullivan and Loring in late March, and the unaffiliated directors were shortly told of it, and advised that detailed letters of inquiry would be addressed to the exchanges. At this time Reilly's report

showed that Pro Fund, Inc., had already been recapturing give-ups on the PBW Exchange, with the exchange's permission, since December 1967, and that, based on information from the Pacific Exchange's president, Reilly thought that Crosby could receive give-ups there "to reduce fund expenses." Neither of these facts were communicated to the unaffiliated directors. It was thought that "they might not see the forest for the trees." No reason was given why it was not immediately decided to "bank" (escrow in the hands of the giving-up brokers) give-ups on those apparently favorable exchanges pending a final resolution of the issue — a procedure not detrimental to the existing give-up procedures if Fund ultimately decided not to recapture.

Two months later Loring's office, characterized by the court as "moving slowly," sent out the promised letters to the exchanges. At the May 29 meeting Loring informed the directors that the manager of the security transactions had been directed to use PBW, when consistent with best execution, and that give-ups on that exchange were being banked pending final determination of whether they were recapturable. By August 1 the same arrangements were instituted with regard to the Pacific Exchange, after it had formally replied that NASD recapture was permissible. The Midwest exchange ultimately wrote that recapture there was not possible. No written replies appear to have been received from the Detroit and Boston exchanges; oral replies from the president of Boston, and a vice-president of Detroit, had been in the negative. On November 27 the directors voted to recapture the banked PBW and Pacific give-ups. On December 5, give-ups were abolished on all exchanges.

These post litem events, if they do not justify plaintiff's charge of misrepresentation to the unaffiliated directors, at least compel the conclusion that the Management defend-

ants' regard for the need of keeping them abreast in the matter of recapture was minimal, and their persistence in continuing to avoid doing so, to prevent injury to Crosby's relationship with its broker-dealers, consciously maximal.[18] We are obliged to reject their brief's protest that they were always open in their disclosure in matters of self-interest just as we do Johnson's testimonial description of the January 1968 SEC release as being "in the nature of a bombshell that hit us." After the 1965 SEC proceedings, the 1966 proceedings, and the 1966 PPI report, the bomb's fuse had been audible to Management for a long time.

Illegality of Recapture

Turning to defendants' asserted excuses for any failure to disclose, we commence with their single most important point, as it would be a short answer to plaintiff's NASD recapture claim if defendants could support the district court's findings and rulings as to its illegality. The district court held,

> "Inscfar as it is a question of fact, this court finds that any scheme involving [Fund's] use of its underwriter Crosby as a recipient of a give-up on the under-

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[18] Plaintiff claims that the unaffiliated directors were told only half-truths. It is certainly so that they were not told all that was in the report, but whether the omissions made the account misleading, as distinguished from incomplete, we need not pursue. It is clear from Management defendants' testimony, as well as from their brief, that the omissions, however motivated, were intentional. We further note that the court's finding that Babcock "talked with Reilly in between his visits to the regional exchanges and received a copy of Reilly's tentative report a few weeks after it was written" (F. 99) does not answer plaintiff's complaint. There was a single conversation, in which Reilly stated he told Babcock his "general findings." There is no reason to suppose that he told Babcock what he recommended not be told to the unaffiliated directors. As to a "few weeks" after March, the testimony was, "May or June." One could not say that Babcock was kept an courant.

standing that Crosby's parent would give [Fund] a credit against charges for investment advisory services is manifestly a rebate within the meaning of the anti-rebate constitutions and rules of the NYSE and other exchanges." (F. 84)

"Inasmuch as an anti-rebate rule is the type of stock exchange rule which has the force of law and is binding alike upon members and customers of the exchange [Silver v. New York Stock Exchange, 373 U.S. 341, 360-361, 83 S.Ct. 1246, 10 L.Ed. 2d 289; Colonial Realty Corporation v. Bache & Co., 358 F.2d 178, 181-182 (2nd Cir.)] all recapture devices which are contrary to the anti-rebate provisions of exchange constitutions are illegal." 316 F.Supp. at 57. (Brackets court's)

It is not clear what the court meant by its statement that the anti-rebate rule "has the force of law." Certainly no criminal sanction attaches to conduct at variance with such a rule, unless the rule happens to parallel a prohibition of the statute or a SEC rule, which this one does not. If the court's phrase, and use of the word "illegal," implies possible criminality we could not agree, and doubt that it was intended to do so.[19] Of course, in a lower key, the violation of exchange rules by Fund might give rise to civil causes of action based on contract. *Roberts* v. *Criss,* 2 Cir., 1920, 266 F. 296, holds that the constitution and rules of an

[19] Defendants make vague references to civil liability under the anti-trust laws and SEC Rule 10b-5, and suggest that by recapturing Fund might have discriminated against other investors. They offer, and we can find, no support for this. Moreover, the court having found that the use that was already being made of give-ups was a form of rebate benefitting Fund, and it being even clearer that it benefitted Management, if any discrimination vis-a-vis other customers was involved it was already extant. If a rebate is either an unlawful price discrimination, or a deceptive or fraudulent practice, it does not matter whether it benefits the fund or its managers, or whether the benefit to the Fund be direct or indirect.

exchange are a contract between the members. *Colonial Realty Corp.* v. *Bache & Co.*, 2 Cir., 1966, 358 F.2d 178, refers to the authority of exchanges to make and enforce their own rules, subject to only broad limitations, as "supervised self-regulation." Whatever the terminology, the nature of the obligations imposed by such rules is to be determined primarily on the basis of the construction which the exchanges that adopted the rules give to them.[20] A court is not free to regard the problem as a statutory interpretation issue of first impression.

The district court, analyzing the issue as an original question, dismissed as irrelevant the wide-spread, accepted use of give-ups, despite its conclusion that they are also rebates, by saying that "a customer-directed give-up which was not used to establish a credit for a customer is no precedent for a customer-directed give-up which does establish such a credit." Recapture, it said, has "the evil consequence of giving back to the customer a dollar credit traceable directly or indirectly to the commission he paid." The fact that there may be some logic in this analysis does not mean that it is correct. The very fact that one type of rebate was uniformly tolerated by the exchanges despite their anti-rebate rules in itself shows that logic alone cannot supply the answer. The controlling answer must be found in how the exchanges, who were the rule-makers, themselves translated their rules. We have seen that the Pacific and PBW exchanges, when confronted with pro-

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[20] Some exchange constitutions provide that any interpretation of the constitution or rules by the exchange's governing body are final and conclusive. See NYSE Const. art. III, § 11; PBW Stock Exch. Const. art. III, § 21; Midwest Stock Exch. Const. art. III, § 1. We assume that similar authority is implicit in the rule making and enforcement powers of the governing bodies of other exchanges in the absence of provisions to the contrary. See Pacific Stock Exch. Const. art. III, § 1(e)-(f); Detroit Stock Exch. Const. art. III, § § 2-5.

posals for recapture, chose to permit it. We do not accept the district court's disregard of that fact, based on its pronouncement that these exchanges were simply mistaken in doing so.[21] (F. 84) This is not to say that the federal courts cannot review an exchange's interpretation of its rules and overrule those that are arbitrary or subjective. *Bright* v. *PBW Exchange,* E.D.Pa. 5/11/71, F.Supp. . The district court perceived a distinction between recapturing give-ups for the benefit of the customer and its underwriter in terms of selling its shares, and recapturing to pay the fee of the adviser who had generated the transaction from which the give-up arose. Accepting that, we could not think it arbitrary, in view of the common factors shared by these two kinds of rebates, for an exchange to say that the distinction did not compel a difference in result. We reject the district court's ruling that the decision was illegal.

Management's Defenses

a) *Self-Dealing*

Management says that it is a "fallacious premise that this is a 'self-dealing' case. It is not." However, after discussing plaintiff's cases on self-dealing, these defendants eventually conclude with the statement that this is not a self-dealing case because they had in fact made disclosure to the unaffiliated directors.[22] This position eliminates the

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[21] Nor were they unaware of their anti-rebate rule. Management's letters of inquiry to which they responded in the affirmative were careful to point out its existence.

[22] Their brief concludes,

> "Because of the decision by disinterested directors and the sanction for management action arising from the disclosures, the 1940 Act and the charter, it follows that management is not guilty of 'self-dealing' and need not have proved, as it did prove, that the policies followed by the Fund were preferable to the plaintiff's claimed alternatives."

necessity of our demonstrating, beyond what we already have done, that this is a self-dealing case if the Management defendants breached their duty of disclosure. On this assumption we may omit discussion of the legal authorities. Whether there was improper failure to disclose remains the critical question.

b) *The Duty To Experiment*

We pass with equal brevity the court's ruling which it stated disposed of any obligation to recapture even if it was not clearly unlawful. The court said,

> "A fiduciary is under no duty to engage in legally doubtful experiments virtually unsupported by custom or convention or court decision." 316 F.Supp. at 57.

In so stating the court answered a wise observation it had made during the course of the trial.

> "It may be that we are moving into an era in which the duty of a trustee is not to rely upon custom, habit and practice of his neighbor, but when he has a sufficiently large interest to make it economically perhaps desirable for him to go and make sure that he has moved in a way which is to the greatest benefit of his beneficiary."

We are not so sure that the court's answer was correct.[23] But in any event, it was the directors of Fund, not Management, who were the ones to make the decision. That they need not have decided to experiment is irrelevant. The

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[23] The court was speaking at trial of the duty of a trustee to seek judicial determination of his obligations. Here we are concerned only with a duty to inquire of the governing boards of the various exchanges whether recapture was possible.

court's ruling does not excuse Management from its failure to disclose and so permit the unaffiliated directors to decide.

c) *Management's Awareness*

The Management defendants are accordingly in chancery unless non-disclosure on their part was reasonable, or at least not grossly unreasonable. Primarily they point to the district court's finding that it is "hard to fault" them for not informing the unaffiliated directors of SEC proceedings conducted by "subordinate SEC employees." The court added that these employees "obviously did not see the technical difficulties with suggestions they informally threw out." (F. 97) As to the level of their experience, Silver, Eisenberg and Rotberg, who conducted the proceedings, were associate directors and assistant general counsel of the SEC. They were subordinate only in the narrow sense that they did not speak as the Commission. Nor is there any evidence that Management representatives were struck, either in June 1965, or in September 1966, by the staff's ignorance of technical difficulties. (*Cf.* n. 14, ante.) Be that as it may, the September 1966 proceedings were shortly followed by the Commission's own, formal, PPI report. Management defendants, whatever their own views on the feasibility of recapture, were then on full notice that the possibility of recapture was a substantial issue that directly involved their self-interest. Any contention that the Commission's views were off-hand or so inconsequential that Management defendants were entitled to keep their own counsel and not even mention the issue to the unaffiliated directors is, to put it bluntly, little short of extraordinary. We may add that Management's willingness to disregard the Commission itself casts some doubt on the bona fides of a claim that the earlier expressed views of the staff were ignored because of its inferior position.

Liability

Enough has been said to show that Management defendants were not guilty of mere negligence. They knew, seemingly in June 1965, and at least after the publication of PPI, that the possibility of recapture was a serious and unresolved issue in the industry. They also knew that it was an issue that involved a potential conflict between their interests and the interests of Fund's shareholders. Their failure to disclose the information available to them to the unaffiliated directors was the result of neither inadvertence nor misapprehension of the facts. Among the abuses enumerated in section 1(b) of the Act, quoted ante, is the operation of investment companies in the interest of advisers, underwriters, and other affiliated persons rather than that of the shareholders. By intentionally pursuing a course of non-disclosure these defendants made the effective functioning of the mechanism protecting Fund from their overreaching impossible. We do not believe that Congress intended that the SEC and the federal courts should be powerless to deal with this kind of conduct, or should excuse it on facts such as those disclosed in the case at bar. *See Aldred Inv. Trust* v. *SEC,* 1 Cir., 1945, 151 F.2d 254, 260, *cert. denied* 326 U.S. 795. Such a construction of the Act would be inconsistent with Congress' direction in section 1(b) that the provisions of the Act be interpreted in accordance with its purpose to "mitigate and, so far as is feasible, to eliminate the conditions enumerated in this section." To hold otherwise would render the benefits Congress sought to obtain through the provisions for unaffiliated directors merely precatory, rather than positive. We therefore conclude that the Management defendants were guilty of gross misconduct within the meaning of the Act in failing to disclose the possibility of NASD recapture to the unaffiliated directors. The two individual manage-

ment defendants, and the Management corporations, must be held liable for damages under section 36.

On the other hand, the unaffiliated directors, with the possible exception of McKenzie, who is not a defendant here, have not been shown to have had any knowledge of the possibility of NASD recapture. Nor did they have any personal conflicting interest which should have sharpened their attention. Plaintiff has not shown that they violated any duty to discover and explore the issue on their own; recapture was a new problem, and they were entitled to rely on the Management defendants, who devoted full time to the investment industry, to advise them of its emergence. While the unaffiliated directors are not free of all obligations to consider matters on their own, we see no basis for holding them in this case.

The Measure of Damages

The problem remaining is that of damages. This, in a sense, falls into three parts: on what exchanges, as of what date, and how much was lost. As to the first, plaintiff has not shown that exchanges other than PBW and Pacific would have allowed recapture. The evidence to the contrary, that some of the others would in fact not have allowed it, is slim, but the initial burden was on the plaintiff. This issue seems to us to fall, strictly, under the question of liability, and not under questions of damages reserved for later determination. It is, accordingly, foreclosed.[24]

On the other hand, plaintiff has shown that PBW and Pacific, when formally asked, responded favorably. No

[24] This may be tested. Suppose that it had not appeared that any exchanges would have permitted NASD recapture. In such event we cannot think that there could have been any further district court proceedings, regardless of our holding herein on other issues.

material changes in the rules of these exchanges have occurred in recent times. Here, accordingly, we take the opposite tack. We do not think it appropriate at this time to reopen the case and determine by hindsight that possibly a different answer might have been received had requests been made of these exchanges sooner. Equally, particularly in the light of the duty that we find faced the unaffiliated directors in this area, we will not reopen to determine whether they would have made a different decision earlier as to recapture from the one they ultimately made. In each respect, Management having wrongfully prevented the matter from coming up, must bear the full consequences.

There is one issue, however, that we believe to be one of fact that the district court, on remand, should resolve from the present record in the light of this opinion. This is the date that Management defendants should have been alerted and started to bank give-ups.[25] We hold, as matter of law, in view of the PPI report, that this date can be no later than March 1, 1967. The district court may conclude, from all the circumstances, that it should have been earlier. When that date has been determined, the Management defendants are to be held liable for all transactions, making allowances for best execution, and all resulting give-ups that could have been recaptured on those two exchanges.

We make no determination as to costs or counsel fees in this court at this time. Costs and counsel fees in the district court to be as it shall determine.

Judgment in accordance herewith.

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[25] Strictly, perhaps, indeed probably, as an abstract matter, they should have banked on all NASD exchanges, but since recovery is now restricted to two, the question is to be limited to those two.

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JUDGMENT

(CAPTION OMITTED)

JUDGMENT

Entered June 4, 1971

This cause came on to be heard on appeal from the United States District Court for the District of Massachusetts, and was argued by counsel.

Upon consideration whereof, It is now here ordered, adjudged and decreed as follows: The amended judgment of the district court is affirmed as to the defendants Burgin, Harding, Hood, and Jones.

The amended judgment of the district court as to the defendants Johnson II, Johnson III, Fidelity Management & Research Company, and The Crosby Corporation is vacated and the cause is remanded to said court for further proceedings not inconsistent with the opinion of this court filed this day.

Costs and counsel fees in the district court are to be as that court determines.

As to costs and counsel fees in this court, this court will consider further presentations.

By the Court:

s/DANA H. GALLUP
Clerk.

AMENDMENT OF OPINION

(CAPTION OMITTED)

ORDER OF COURT

Entered June 23, 1971

The opinion dated June 4, 1971 is hereby amended as follows.

1. The word "(Rothberg?)" at line 8 of slip page 15 [line 24 of page B-15] is excised.

2. The last sentence of the section entitled "a) *Self-Dealing*" viz., the sentence at lines 5 and 6 of slip page 25 [lines 5 and 6 of page B-26], is stricken and there is substituted therefor the following.

> "At the same time we note that Management defendants' position appears to be an open acceptance of what we hold to be the fact, that this is a clear conflict of interest case that routinely calls for disclosure quite apart from any special burden that may be implicit in the Investment Company Act."

3. Footnote 25 at slip page 29 [page B-30] is augmented by adding the following sentence.

> "However, the district court may well find that at a reasonable interval after a final determination to bank give-ups should have been made it would have been learned that exchanges other than PBW and Pacific

would have ruled against indirect recovery and that thereafter proper practice would have been, consistent with best execution, to make as many transactions as possible on the two favorable exchanges."

By the Court:

s/Dana H. Gallup
Clerk.

Enter:

s/Aldrich, Ch. J.

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APPENDIX C

RELEVANT STATUTORY AND REGULATORY PROVISIONS

SHERMAN ACT

Section 1. Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is hereby declared to be illegal: *Provided,* That nothing herein contained shall render illegal, contracts or agreements prescribing minimum prices for the resale of a commodity which bears, or the label or container of which bears, the trade mark, brand, or name of the producer or distributor of such commodity and which is in free and open competition with commodities of the same general class produced or distributed by others, when contracts or agreements of that description are lawful as applied to intrastate transactions, under any statute, law, or public policy now or hereafter in effect in any State, Territory, or the District of Columbia in which such resale is to be made, or to which the commodity is to be transported for such resale, and the making of such contracts or agreements shall not be an unfair method of competition under section 5, as amended and supplemented, of the Act entitled "An Act to create a Federal Trade Commission, to define its powers and duties, and for other purposes," approved September 26, 1914: *Provided further,* That the preceding proviso shall not make lawful any contract or agreement, providing for the establishment or maintenance of minimum resale prices on any commodity herein involved, between manufacturers, or between producers, or between wholesalers, or between brokers, or between factors, or between

retailers, or between persons, firms, or corporations in competition with each other. Every person who shall make any contract or engage in any combination or conspiracy hereby declared to be illegal shall be deemed guilty of a misdemeanor, and, on conviction thereof, shall be punished by fine not exceeding fifty thousand dollars, or by imprisonment not exceeding one year, or by both said punishments, in the discretion of the court. 15 U.S.C. § 1.

Investment Company Act of 1940

Injunctions Against Gross Abuse

Sec. 36.* The Commission is authorized to bring an action in the proper district court of the United States or United States court of any Territory or other place subject to the jurisdiction of the United States, alleging that a person serving or acting in one or more of the following capacities has been guilty, after the enactment of this title and within five years of the commencement of the action, of gross misconduct or gross abuse of trust in respect of any registered investment company for which such person so serves or acts:

(1) as officer, director, member of an advisory board, investment adviser, or depositor; or

(2) as principal underwriter, if such registered company is an open-end company, unit investment trust, or face-amount certificate company.

If the Commission's allegations of such gross misconduct or gross abuse of trust are established, the court shall enjoin such person from acting in such capacity or capacities either permanently or for such period of time as it in its discretion shall deem appropriate. 15 U.S.C. § 80a-35.

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* As in effect prior to December 14, 1970.

SECURITIES EXCHANGE ACT OF 1934

SECTION 5. It shall be unlawful for any broker, dealer, or exchange, directly or indirectly, to make use of the mails or any means or instrumentality of interstate commerce for the purpose of using any facility of an exchange within or subject to the jurisdiction of the United States to effect any transaction in a security, or to report any such transaction, unless such exchange (1) is registered as a national securities exchange under section 6 of this title, or (2) is exempted from such registration upon application by the exchange because, in the opinion of the Commission, by reason of the limited volume of transactions effected on such exchange, it is not practicable and not necessary or appropriate in the public interest or for the protection of investors to require such registration. 15 U.S.C. § 78e.

SECTION 6. (a) Any exchange may be registered with the Commission as a national securities exchange under the terms and conditions hereinafter provided in this section, by filing a registration statement in such form as the Commission may prescribe, containing the agreements, setting forth the information, and accompanied by the documents, below specified:

(1) An agreement (which shall not be construed as a waiver of any constitutional right or any right to contest the validity of any rule or regulation) to comply, and to enforce so far as is within its powers compliance by its members, with the provisions of this title, and any amendment thereto and any rule or regulation made or to be made thereunder;

(2) Such data as to its organization, rules of procedure, and membership, and such other information as the Commission may by rules and regulations require as being

necessary or appropriate in the public interest or for the protection of investors;

(3) Copies of its constitution, articles of incorporation with all amendments thereto, and of its existing bylaws or rules or instruments corresponding thereto, whatever the name, which are hereinafter collectively referred to as the "rules of the exchange"; and

(4) An agreement to furnish to the Commission copies of any amendments to the rules of the exchange forthwith upon their adoption.

(b) No registration shall be granted or remain in force unless the rules of the exchange include provision for the expulsion, suspension, or disciplining of a member for conduct or proceeding inconsistent with just and equitable principles of trade, and declare that the willful violation of any provisions of this title or any rule or regulation thereunder shall be considered conduct or proceeding inconsistent with just and equitable principles of trade.

(c) Nothing in this title shall be construed to prevent any exchange from adopting and enforcing any rule not inconsistent with this title and the rules and regulations thereunder and the applicable laws of the State in which it is located.

(d) If it appears to the Commission that the exchange applying for registration is so organized as to be able to comply with the provisions of this title and the rules and regulations thereunder and that the rules of the exchange are just and adequate to insure fair dealing and to protect investors, the Commission shall cause such exchange to be registered as a national securities exchange.

(e) Within thirty days after the filing of the application, the Commission shall enter an order either granting or,

after appropriate notice and opportunity for hearing, denying registration as a national securities exchange, unless the exchange applying for registration shall withdraw its application or consent to the Commission's deferring action on its application for a stated longer period after the date of filing. The filing with the Commission of an application for registration by any exchange shall be deemed to have taken place upon the receipt thereof. Amendments to an application may be made upon such terms as the Commission may prescribe.

(f) An exchange may, upon appropriate application in accordance with the rules and regulations of the Commission, and upon such terms as the Commission may deem necessary for the protection of investors, withdraw its registration. 15 U.S.C. § 78f.

SECTION 19. (a) The Commission is authorized, if in its opinion such action is necessary or appropriate for the protection of investors—

(1) After appropriate notice and opportunity for hearing, by order to suspend for a period not exceeding twelve months or to withdraw the registration of a national securities exchange if the Commission finds that such exchange has violated any provision of this title or of the rules and regulations thereunder or has failed to enforce, so far as is within its power, compliance therewith by a member or by an issuer of a security registered thereon.

(2) After appropriate notice and opportunity for hearing, by order to deny, to suspend the effective date of, to suspend for a period not exceeding twelve months, or to withdraw, the registration of a security if the Commission finds that the issuer of such security has failed to comply with any provision of this title or the rules and regulations thereunder.

(3) After appropriate notice and opportunity for hearing, by order to suspend for a period not exceeding twelve months or to expel from a national securities exchange any member or officer thereof whom the Commission finds has violated any provision of this title or the rules and regulations thereunder, or has effected any transaction for any other person who, he has reason to believe, is violating in respect for such transaction any provision of this title or the rules and regulations thereunder.

(4) And if in its opinion the public interest so requires, summarily to suspend trading in any registered security on any national securities exchange for a period not exceeding ten days, or with the approval of the President, summarily to suspend all trading on any national securities exchange for a period not exceeding ninety days.

(b) The Commission is further authorized, if after making appropriate request in writing to a national securities exchange that such exchange effect on its own behalf specified changes in its rules and practices, and after appropriate notice and opportunity for hearing, the Commission determines that such exchange has not made the changes so requested, and that such changes are necessary or appropriate for the protection of investors or to insure fair dealing in securities traded in upon such exchange or to insure fair administration of such exchange, by rules or regulations or by order to alter or supplement the rules of such exchange (insofar as necessary or appropriate to effect such changes) in respect of such matters as (1) safeguards in respect of the financial responsibility of members and adequate provision against the evasion of financial responsibility through the use of corporate forms or special partnerships; (2) the limitation or prohibition of the registration or trading in any security within a specified period after the issuance or primary distribution thereof; (3) the

listing or striking from listing of any security; (4) hours of trading; (5) the manner, method, and place of soliciting business; (6) fictitious or numbered accounts; (7) the time and method of making settlements, payments, and deliveries and of closing accounts; (8) the reporting of transactions on the exchange and upon tickers maintained by or with the consent of the exchange, including the method of reporting short sales, stopped sales, sales of securities of issuers in default, bankruptcy or receivership, and sales involving other special circumstances; (9) the fixing of reasonable rates of commission, interest, listing, and other charges; (10) minimum units of trading; (11) odd-lot purchases and sales; (12) minimum deposits on margin accounts; and (13) similar matters.

(c) The Commission is authorized and directed to make a study and investigation of the rules of national securities exchanges with respect to the classification of members, the methods of election of officers and committees to insure a fair representation of the membership, and the suspension, expulsion, and disciplining of members of such exchanges. The Commission shall report to the Congress on or before January 3, 1935, the results of its investigation, together with its recommendations.

(d) The Commission is authorized and directed to make a study and investigation of the adequacy, for the protection of investors, of the rules of national securities exchanges and national securities associations, including rules for the expulsion, suspension or disciplining of a member for conduct inconsistent with just and equitable principles of trade. The Commission shall report to the Congress on or before April 3, 1963, the results of its study and investigations, together with its recommendations, including such recommendations for legislation as it deems advisable. The Commission is authorized to appoint, without regard to the

civil service laws, rules, and regulations, such personnel as the Commission deems advisable to carry out such study and investigation and to fix their respective rates of compensation without regard to the Classification Act of 1949, as amended, but no such rate shall exceed $18,500 per annum. To carry out such study and investigation there is hereby authorized to be appropriated the sum of $95,000. 15 U.S.C. § 78s.

Regulations and Rules Under the Securities Exchange Act of 1934

Reg. § 240.6a-2 (Rule 6a-2)

Reg. § 240.6a-2. Prior to June 30 of each year each exchange registered as a national securities exchange or exempted from such registration shall file an annual amendment setting forth:

(a) All changes, and the effective dates thereof, which have been affected in any of the information contained or incorporated in the statement, or in exhibits A(1), A(2), A(3), B, C and D, and which have not previously been reported in an annual amendment. Such amendment shall bring the statement and exhibits A(1), A(2), A(3), B, C and D up to date as of the latest practicable date within one month of the date on which the amendment is filed. In the event that no changes have occurred in any of this material during the period covered by the amendment, a statement to that effect shall be set forth in the amendment.

(b) Complete exhibits E and F as of the end of the latest fiscal year of the exchange, and of each affiliate and subsidiary listed on answer to item 8 of the statement. In the event that exhibit F is inapplicable to the exchange for the reason that it has no affiliate or subsidiary, the amendment shall include a statement to that effect in lieu of the information called for in exhibit F.

(c) Complete exhibits G, H, I, J, K, L and M. The information contained in these exhibits shall be up to date as of the latest practicable date within 3 months of the date on which the annual amendment is filed.

Reg. § 240.6a-3 (Rule 6a-3)

Reg. § 240.6a-3. Each exchange registered as a national securities exchange or exempted from such registration shall furnish the following supplemental material.

(a) Within 10 days after any action is taken which renders no longer accurate any of the information contained or incorporated in the statement or in any exhibit (except exhibits E, F, L and M), or in any amendment thereto, the exchange shall file with the Commission written notification in triplicate setting forth the nature of such action and the effective date thereof. Such notification may be filed either in the form of a letter or in the form of a notice made generally available to members of the exchange.

(b) Within 10 days after issuing or making generally available to members of the exchange any material (including notices, circulars, bulletins, lists, periodicals, etc.) the exchange shall file with the Commission three copies of such material.

(c) Within 15 days after the end of each calendar month the exchange shall file with the Commission a report concerning the securities sold on such exchange during such calendar month, setting forth:

(1) the number of shares of stock sold and the aggregate dollar amount thereof;

(2) the principal amount of bonds sold and the aggregate dollar amount thereof; and

(3) the number of units of rights and warrants sold and the aggregate dollar amount thereof.

Reg. § 240.17a-8 (Rule 17a-8)

Reg. § 240.17a-8. (a) Each national securities exchange shall file with the Commission three copies of a report of any proposed amendment or repeal of, or any addition to, its rules not less than three weeks (or such shorter period as the Commission may authorize) before any action is taken on such amendment, repeal or addition by the members of such exchange or by any governing body thereof: *Provided, however,* That under emergency circumstances such report need not be filed as hereinabove provided, but in such case the exchange shall file three copies of a report giving the Commission as much notice as the circumstances permit, together with a written statement of the reasons why the filing of a report as above provided was impracticable.

(b) If any change is made in a proposed amendment, repeal or addition after the report is filed with the Commission, the three-week period (or such shorter period as the Commission may authorize) will commence to run from the time the Commission is notified of such change unless the change does not alter the substance of the proposed amendment, repeal or addition, or the change is made in conformity to a suggestion by the Commission.

(c) For the purpose of this rule the term "rules" of an exchange shall mean its constitution, articles of incorporation, by-laws, or rules or instruments corresponding thereto whatever the name, and its stated policies.

(d) The failure on the part of an exchange to file a report as hereinabove provided shall not affect the validity, force or effect of any rule of the exchange or of any exchange action or omission to act thereunder.

Proposed Rules Under the Securities Exchange Act of 1934

Proposed Rule 10b-10

(1) It shall be unlawful for any registered investment company or affiliated person of such registered investment company to directly or indirectly, to order or request any broker or dealer:

(a) to pay or arrange for the payment, directly or indirectly, of all or any portion of a commission on any securities transaction to any broker, dealer or any other person *unless* pursuant to a written contract the full amount of such remittance is required to be paid over to such registered investment company, or fees owed by or charged to such registered investment company are required to be reduced in an amount equal to the remittance;

(b) to designate or employ any broker or dealer on any transaction to transmit, execute or clear a commission or to perform any other function for which compensation is required or made *unless* pursuant to a written contract the full amount of such compensation is required to be paid over to such registered investment company or fees owed by or charged to such registered investment company are required to be reduced in an amount equal to such compensation.

(2) For the purposes of this rule a person is affiliated with a registered investment company if such person:

(a) is an officer, director, trustee, employee, investment adviser, member of an advisory board, de-

positor, promoter of or principal underwriter for the registered investment company, or

(b) directly or indirectly, through one or more intermediaries, controls, or is controlled by, or is under common control with the registered investment company, its investment adviser or principal underwriter, or

(c) directly or indirectly owns, controls, or holds with the power to vote, five per centum or more of the outstanding voting securities of the registered company.

Proposed Rule 10b-10 was withdrawn without comment on November 7, 1969. Securities Exchange Act of 1934 Release No. 8743. R.5402.

Forms Under the Securities Exchange Act of 1934

Form 1

STATEMENT

SECURITIES AND EXCHANGE COMMISSION

Washington, D. C.

Statement to be Filed in Connection With an Application for Registration or Exemption From Registration as a National Securities Exchange Under the Securities Exchange Act of 1934.

• • • •

AGREEMENTS

21. Does the exchange agree (without waiving any constitutional right or any right to contest the validity of any rule or regulation) to comply, and to enforce so far as is

within its powers compliance by its members, with the provisions of Title I of the Securities Exchange Act of 1934 and any amendment thereto and any rule or regulation made or to be made thereunder?

22. Does the exchange agree to furnish to the Commission copies of any amendments to the "rules of the exchange," as defined in Section 6(a)(3) of the Securities Exchange Act of 1934, forthwith upon their adoption?

EXHIBITS

Exhibits to be filed in connection with an Application for Registration or Exemption from Registration as a National Securities Exchange under the Securities Exchange Act of 1934.

Exhibit A(1). A copy of the constitution, articles of incorporation or association with all amendments thereto, and of existing by-laws or rules or instruments corresponding thereto, whatever the name, of the exchange.

Exhibit A(2). A copy of all written rulings, settled practices having the effect of rules, and interpretations of the Governing Board or other committee of the exchange in respect of any of the provisions of the constitution, by-laws, rules or trading practices of the exchange, which are not included in the material submitted under Exhibit A(1).

Exhibit A(3). A copy of the constitution, articles of incorporation or association with all amendments thereto, and of existing by-laws or rules or instruments corresponding thereto, whatever the name, of each affiliate and subsidiary listed in answer to item 8 of the Statement.

APPENDIX D

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APPENDIX D

CONSTITUTIONAL PROVISIONS AND RULES OF RELEVANT STOCK EXCHANGES*

NEW YORK STOCK EXCHANGE
Constitution

ARTICLE XV, SECTION 1

Commissions shall be charged and collected upon the execution of all orders for the purchase or sale for the account of members or allied members or of parties not members or allied members of the Exchange, of securities admitted to dealings upon the Exchange and these commissions shall be at rates not less than the rates in this Article prescribed; and shall be net and free from any rebate, return, discount or allowance made in any shape or manner, or by any method or arrangement direct or indirect. No bonus or percentage or portion of a commission, whether such commission be at or above the rates herein established, or any portion of a profit except as may be specifically permitted by the Constitution or a rule adopted by the Board of Governors, shall be given, paid or allowed, directly or indirectly, or as a salary or portion of a salary, to a clerk or person for business sought or procured for any member or allied member of the Exchange or member firm or member corporation.

Notwithstanding the provisions of this Article, any member of the Exchange or member firm or member corporation holding a membership or associate membership in another exchange located in the United States, or holding a membership or associate membership in a Canadian exchange, or

* As in effect prior to December 5, 1968.

registered with a Canadian exchange as being entitled to a return of commission from members of said exchange, may in respect of transactions made on such other exchange charge the rates of commission prescribed by such other exchange.

ARTICLE XV, SECTION 2

Stocks, rights and warrants (hereinafter referred to as "stocks")

(a) On business for non-members and allied members, including joint account transactions in which any such person is interested:

(1) On stocks selling at $1.00 per share and above commissions shall be based upon the amount of money involved in a single transaction and shall be not less than the rates hereinafter specified:

• • • •

PHILADELPHIA-BALTIMORE-WASHINGTON STOCK EXCHANGE

Constitution

ARTICLE XX, SECTION 1

Commissions shall be charged and collected upon the execution of all orders for the purchase or sale for the account of members or of non-members of the Exchange, of securities admitted to dealing upon the Exchange, except under such Rules as may be adopted by the Board of Governors with respect to special offerings and except as herein further expressly provided; these commissions shall be at rates not less than the rates in this Article prescribed;

and they shall be absolutely net and free from any rebate, return, discount or allowance, in any shape or manner, or by any method or arrangement, direct or indirect.

No bonus or percentage or portion of a commission, whether such commission be at or above the rates herein established, or any portion of a profit, shall be given, paid or allowed, directly or indirectly, or as a salary or as a portion of a salary, to any person or persons for business sought or procured for any member, member firm or member corporation of the Exchange, except as herein expressly permitted.

• • • •

ARTICLE XX, SECTION 2

Commissions shall be as follows:

STOCKS, RIGHTS AND WARRANTS
(Hereinafter referred to as "stocks")

(a) On business for non-members of the Exchange, including joint account transactions in which a non-member is interested; and on transactions for partners not members of the Exchange, the commission rate per share shall be not less than the following:

• • • •

(b) On business for members, member firms, and member corporations of the Exchange when a principal is not given up, commissions shall be as mutually agreed subject to such regulations as the Board of Governors may deem proper.

Members and member organizations may accept orders for execution on the Exchange from Investment Funds, registered under the Investment Company Act of 1940, on a

give-up basis to include other members, subject to the following conditions:

1. *Designate Give-up:* The Investment Fund shall in each instance, at the time the order is placed, designate it specifically as one to include on a give-up basis other members.

2. *Give-up for Member:* If the order is designated as one to be executed on a give-up basis for members, the executing member may credit not to exceed 65% of the commission earned to a special account to be identified in the member's records as "Member's Investment Fund Give-up Account."

3. *Give-up for Non-Member:* If the order is designated as one to be executed on a give-up basis for non-members who are members of the National Association of Securities Dealers, the executing member may credit not to exceed 40% of the commission earned to a special account to be identified in the member's records as "Non-Member's Investment Fund Give-up Account".

4. *Give-up for Members and Non-Members:* If the order is designated as one to be executed on a give-up basis for both members, and non-members as defined in section 3, the executing member shall not credit to the respective special give-up accounts more than a combined total of 50% of the commission earned.

5. *Disbursement in Calendar Year:* All commissions credited to special Investment Fund Give-up Accounts shall be disbursed as provided in Paragraph 2, during the calendar year in which they are credited to such accounts.

6. *Members Advise Exchange:* Members proposing to transact business for Investment Funds pursuant to the

foregoing shall so advise the Exchange in writing, stating that such business has been or may be accepted.

* * * *

ARTICLE XX, SECTION 6

No member, member firm or member corporation shall make a proposition for the transaction of business at less than the minimum rates of commission prescribed in this Article.

ARTICLE XX, SECTION 7

Any return, rebate, discount or allowance of commissions resulting from an order given by a member or member firm or member corporation and payable by a member or member firm or member corporation of another exchange in connection with the execution of such order shall be collected by the member or member firm or member corporation giving such order and may not be shared with a non-member of the Exchange.

ARTICLE XXV, SECTION 1

Whenever fifty members of the Stock Exchange shall offer, in writing, any amendment to the Constitution, it shall be submitted to the Board of Governors, who shall, within two weeks after the proposed amendment is filed with the Secretary, submit it to the membership for vote thereon by ballot, under such regulations as the Chairman of the Board, with the approval of the Board of Governors, may direct. Each member of the Exchange in good standing may vote in person or by mail. If the number of members participating in the balloting exceeds one-half of the number of memberships then outstanding and the proposed

amendment is approved by the affirmative vote of a majority of the votes cast, it shall thereupon become a part of the Constitution.

Amended

December 16, 1964, effective immediately.

Article XXV, Section 2

Any amendment to the Constitution originating in the Board of Governors shall be proposed at a regular or special meeting of the Board. If approved by twelve of the Governors, it shall be announced to the Exchange forthwith and conspicuously posted for a period of ten days, and copies thereof shall be sent to each member of the Exchange.

If, during the period of ten days, a written request of not less than seventeen members of the Exchange be filed with the Secretary for a special meeting of the Exchange to consider the amendment, the Chairman of the Board shall call such meeting, at which meeting each member of the Exchange in good standing may vote in person or by mail. If the number of members participating in the balloting exceeds one-half of the number of memberships then outstanding, and the proposed amendment is approved by the affirmative vote of a majority of the votes cast, it shall thereupon become a part of the Constitution.

In the absence of such request for a special meeting of the Exchange, the Board of Governors, after the expiration of such period of ten days, may consider the proposed amendment at any regular or special meeting of the Board, and, if the proposed amendment is adopted by a vote of

fifteen members of the Board, it shall thereupon become a part of the Constitution

All changes in the Constitution shall be printed and posted for ten days, and copies thereof shall be sent to each member of the Exchange.

Rules

Rule 677

No member or member organization shall directly or indirectly pay any expense pertaining to the office of a non-member, except that the Committee may permit the payment by a member or member organization of part or all of the cost of a means of communication between an office of a member or member organization and a non-member organization.

Pacific Coast Stock Exchange

Constitution

Article XIV, Section 1

Commissions shall be charged and collected by members and member firms upon the execution of all orders involving the purchase or sale of securities admitted to dealings on the Exchange for the account of others. Commissions shall be charged and collected pursuant to rules and regulations prescribed by the Board of Governors and shall be at rates not less than those established by said Board. Commissions shall be net and free from any rebate, return,

discount or allowance in any shape, manner, method or arrangement direct or indirect.

Article XIV, Section 2 (a)

Unless otherwise ruled by the Board of Governors commissions shall be charged and collected by members on all transactions in securities admitted to dealings on the Exchange for the accounts of non-members of the Exchange including joint accounts of members with non-members. Such commissions shall be not less than the minimum rates of commission prescribed therefor by Rules of the Board of Governors.

Article XIV, Section 4

A member or member firm proposing or offering to transact business at rates less than the minimum commission rates established by the Board of Governors or in a manner designed to avoid or evade commission rules and regulations prescribed by the Board shall be deemed to have violated this Constitution.

Article XVIII, Section 1

The Board of Governors may from time to time amend this Constitution by the affirmative vote of not less than seven of its members. Each such amendment shall thereafter be submitted forthwith to each member of the Exchange, and when and if it is approved in writing by the affirmative vote of at least three-fourths of the members of the Exchange voting but not less than a majority of the members of the Exchange, it shall thereupon become effective.

Article XVIII, Section 2

The Constitution shall be interpreted when necessary by the Board of Governors, which interpretation shall be final.

Rules

Rule IV, Section 1(a)

On business for non-members (except as in the subsequent subdivision of the Section provided) including (i) joint account transactions in which a non-member is interested, unless said non-member is approved to receive the rates of commissions set forth in Section 2 of this Rule; (ii) transactions for individual non-member partners, officers, directors or stockholders of member firms; the commission rates shall be not less than the following:

Rule IV, Section 1(a)(1)

On stocks, rights and warrants selling at $1.00 per share and above, commissions shall be based upon the amount of money involved in a single transaction and shall be not less than the rates hereinafter specified:

• • • •

Rule IV, Section 2

On business for approved non-members who are members of a national securities exchange, or a national securities association, or the Honolulu Stock Exchange, or who are engaged in the banking business in the United States, the minimum commission rates shall be not less than 75% of the minimum commission rates set forth in Section 1 of this Rule.

RULE IV, SECTION 3(a)

On securities subject to a transfer charge by the issuing corporation, the total amount of the transfer fee involved shall be charged to the purchasing customer.

RULE IV, SECTION 3(b)

No member shall, directly or indirectly, by agreement or otherwise, assume or bear for his own account or relieve his principal from any part of any stamp tax imposed by the United States or by any State on transfers or sales of securities.

RULE IV, SECTION 3(d)

No registered employee shall, directly or indirectly, rebate to any person, firm or corporation any part of the compensation he may receive as a registered employee; nor shall he pay such compensation or any part thereof, directly or indirectly, to any person, firm, or corporation, as a bonus, commission, fee or other consideration, for business sought or procured for him or any member of the Exchange or firm registered thereon.

RULE IV, SECTION 5

Members and member firms may accept orders for execution on the Exchange from Investment Funds, registered under the Investment Company Act of 1940, on a give-up basis to include other members and approved non-members entitled to Preferred Rates of Commission but strictly subject to the following conditions:

• • • •

RULE IV, SECTION 5(b)(2)

If the order is designated as one to be executed on a give-up basis for approved non-members, the executing

member may credit not to exceed 25% of the commission earned to a special account to be identified in the member's records as "Approved Non-Member's Investment Fund Give-up Account."

Rule VIII, Section 3(d)

No registered employee shall, directly or indirectly, rebate to any person, firm or corporation any part of the compensation he may receive as a registered employee; nor shall he pay such compensation or any part thereof, directly or indirectly, to any person, firm, or corporation, as a bonus, commission, fee or other consideration, for business sought or procured for him or any member of the Exchange or firm registered thereon.

Rule IX, Section 3

Except for a firm primarily engaged in trading for its own account, or acting as a floor broker, no firm shall be eligible for member firm status unless it is primarily engaged in transacting business directly with the public in the purchase and sale of securities through its own partners, officers or sales representatives. If a firm has a parent which is engaged in the securities business, the principal portion of such parent's securities business shall also be that of transacting business directly with the public in the purchase and sale of securities through its own partners, officers or sales representatives. A preponderance of the business of a member firm shall be for the account of persons other than a parent who is not itself a broker or dealer in securities. The term "parent" means any person, firm or corporation who directly or indirectly controls a firm. Nothing herein contained shall abrogate the right of the Board of Governors to impose additional requirements for

member firms pursuant to Section 1(a) of Article IX of the Constitution.

Adopted.

July 1, 1965.

Rule IX, Section 5(a)(6)

The requirement of Section 8(b) of Article IX of the Exchange Constitution that all voting stockholders of a corporate member firm shall be active in the business shall not be deemed to be met in any case where a voting stockholder or proposed voting stockholder is a corporation, unless the principal business of that corporation and of its parents and subsidiaries, taken on a consolidated basis, shall be that of a broker-dealer in securities. Corporate member firms in good standing as of October 1, 1965 are exempted from this rule, except as to subsequent transfers of voting stock to corporations which were not affiliated with such firms prior to such date.

Adopted.

September 9, 1965.

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Approved Non-Member Application

PACIFIC COAST STOCK EXCHANGE

618 SO. SPRING STREET
LOS ANGELES 90014

301 PINE STREET
SAN FRANCISCO 94104

Preferred Rates of Commission

1. *Eligibility.* The following are eligible to apply for PREFERRED RATES OF COMMISSION on Pacific Coast Stock Exchange:

   (a) Banks in the United States; and

   (b) Members in good standing of

      (i) National Association of Securities Dealers, Inc.

      (ii) A national securities exchange.

2. *Application.* Applicants may secure application forms from the Exchange or its members. When an application is completed and filed with the Exchange, it will receive prompt consideration; and the applicant will be advised immediately upon approval.

3. *Earnings.* Approved applicants will be charged 75% of the Exchange's minimum public rate of commissions on their transactions on the Exchange, enabling them to earn 25% on orders which are executed on their behalf on Pacific Coast Stock Exchange.

4. *Mutual Fund Business.* Additional earnings may accrue to those approved for the Preferred Rate through sharing in commissions on Exchange transactions for Mutual Funds.

5. *Period.* For purposes of uniformity, the Preferred Rate is on a calendar year basis from January 1 through December 31.

6. *Annual Renewal - Annual Fee.* Approved applicants may continue to receive the Preferred Rate during succeeding years by remitting the annual fee of $100. Statements therefor will be rendered in December each year. Checks should be made payable to Pacific Coast Stock Exchange.

7. *Applications after January 1 - Fee.* Applications filed after January 1 should be accompanied by a fee at the rate of $10 per month for the unexpired months through December 31. with a maximum of $100. Applications filed in December should be accompanied by a check for $100, the Annual Fee for the subsequent calendar year.

8. *Placing Orders.* Orders may be placed directly with an Exchange member or through a non-member approved to receive the Preferred Rate. Those approved for and accepting the Preferred Rate *must* charge their customers the minimum public rate unless the customer is one approved to receive the Preferred Rate.

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PACIFIC COAST STOCK EXCHANGE

618 SO. SPRING STREET
LOS ANGELES 90014

301 PINE STREET
SAN FRANCISCO 94104

APPLICATION FOR PREFERRED RATES OF COMMISSION

Gentlemen:

The undersigned, the applicant, hereby applies for Preferred Rates of Commission of the Pacific Coast Stock Exchange, and submits the following information as an integral part and in support of this application:

1. Name of applicant .....

2. Address of main office .....

3. Nature of organization .....
(Sole Proprietorship, Partnership, Corporation)

Date of organization .....

4. Type of business .....

5. Names of partners or officers and directors .....

.....

.....

6. Applicant is a member of the following stock or commodity exchanges: .....

.....

7. Applicant is a member of the National Association of Securities Dealers .....
(Answer yes or no)

(a) Date membership effective .....

8. If the applicant or any of its predecessors, partners, officers or directors have ever been (1) enjoined from selling or dealing in securities, (2) suspended or expelled from any stock or commodity exchange or refused membership therein, (3) subject to a disciplinary or business conduct hearing before any securities regulatory body or (4) failed in business, compromised with creditors or taken advantage of a bankruptcy or similar act, give particulars:

.....

.....

9. The applicant submits independently audited financial statements to a national securities exchange or association and/or federal or state commissions at least once each calendar year and the date of such last independent audit was .....

IN CONSIDERATION OF THE PACIFIC COAST STOCK EXCHANGE EXTENDING PREFERRED RATES OF COMMISSION, THE APPLICANT HEREBY AGREES AS FOLLOWS WITH RESPECT TO TRANSACTIONS EXECUTED ON SAID EXCHANGE:

A. This application is made pursuant and subject to the provisions of the Constitution and Rules of Pacific Coast Stock Exchange and all transactions shall be conducted in accordance therewith, as the same now stand or hereafter may be supplemented, revised or repealed;

B. The applicant is required to and will observe the provisions of the Securities Exchange Act of 1934 as

amended and rules and regulations pursuant thereto in all dealings on Pacific Coast Stock Exchange;

C. On transactions executed on Pacific Coast Stock Exchange on which the applicant receives Preferred Rates of Commission, the applicant will charge customers (including partners, officers, directors or stockholders of the applicant) not less than the minimum public rates of commission as established by said Exchange. The applicant will not directly or indirectly extend or grant the Preferred Commission Rate to another not approved by the Exchange to receive such rate;

D. The applicant will submit a record of any or all transactions, on which the Preferred Rate applied, to the Exchange upon its request and all records respecting such transactions shall be subject to examination by an authorized representative of the Exchange at any time;

E. The applicant will promptly notify the Exchange of any change in the status of its membership in a national securities exchange or in a national securities association, including resignation, suspension or expulsion therefrom;

F. The applicant will not directly or indirectly, publicly or privately, orally or in writing, publish, state, infer or claim membership in Pacific Coast Stock Exchange;

G. The applicant understands that the extension of Preferred Rates of Commission is entirely voluntary on the part of the Exchange and subject to withdrawal at any time within the sole discretion of the Exchange;

H. The approval or disapproval of this application shall be solely within the discretion of Pacific Coast Stock Exchange.

The undersigned hereby certifies that all statements made or contained herein are true and correct. Additional information in support of this application or to justify the continued extension of Preferred Rate of Commission, if granted, will be submitted upon request. However, the undersigned shall have and reserves the right to withdraw or cancel this application at any time by written notice thereof to the Exchange whereupon the relationship hereunder shall terminate forthwith.

(Signed) .....
(Firm)

By .....
(Title)

(CORP. SEAL)

Date .....

(If firm is Partnership a General Partner must sign. If a Corporation an Officer must sign and the corporate seal must be affixed.)

Use and attach hereto separate sheets if necessary to submit data required.

BOSTON STOCK EXCHANGE

Constitution

ARTICLE XVIII, SECTION 1

Commissions shall be charged and collected under all circumstances and upon all transactions, both purchases and sales of securities dealt in upon the Exchange. Such

commission shall be at rates not less than the rates prescribed in this Article, and shall be absolutely net and free from all or any abatement, return, discount, or allowance in any shape or manner whatsoever, or by any method or arrangement, direct or indirect; and no bonus, percentages, or portion of the commission so established shall be given, paid, or allowed, directly or indirectly, to any clerk, or person for business sought or procured for any member of the Exchange, except as may be specifically permitted by the Constitution or a rule adopted by the Board of Governors.

ARTICLE XVIII, SECTION 2(a)

Except as specifically provided in rules applicable to all members or non-members without exception and adopted by the Board of Governors, on all business for parties not members of the Exchange, including joint account transactions in which a non-member is interested and transactions for allied members, except as provided in Section 3 of this Article with respect to member-firms and member-corporations, the commission charge shall not be less than the rates hereinafter specified.

• • • •

Rules

CHAPTER VII, SECTION 4

Members and member-organizations may pay "give-ups" on the following terms:

(a) Up to a maximum of 50% of the total commission may be given up to members and member-organizations.

(b) Up to a maximum of 40% of the total commission may be given up to persons other than members and member-organizations, provided that such persons must

either be members in good standing of the National Association of Securities Dealers or be members or member-organizations of a national securities exchange.

(c) In no event may more than an aggregate of 50% of the total commission be given up on a single order.

• • • •

Detroit Stock Exchange

Constitution

Article XVIII, Section 1

Commissions shall be charged and collected upon the execution of all orders for the purchase or sale for the account of parties not members of the Exchange of securities admitted to dealing upon the Exchange and these commissions shall be at rates not less than those provided in this Article and shall be net and free from any rebate, return, discount or allowance in any shape or manner to the person or persons for whose account such orders shall be executed, or to anyone acting for him or them, whether in a representative capacity or otherwise, whether such rebate, return, discount or allowance be paid, credited, or effected by any method or arrangement, direct or indirect, except as provided in Section 9, Chapter 7 of the Rules. No bonus or percentage or portion of a commission, whether such commission be at or above the rates herein provided, or any portion of the profit, except as may be specifically permitted by this Constitution or a rule adopted by the Governing Committee, shall be given, paid or allowed, directly or indirectly, to the person or persons for whose account such orders shall be executed, or to any person acting for him or them, either in a representative capacity or otherwise, whether the same be paid as a salary to an

employee of any person or firm other than the person or firm charging the commission involved, or whether such salary shall be for business sought or procured for a member of the Exchange or firm registered thereon.

Article XVIII, Section 2

Non-Member commissions shall be based upon the money involved in transactions for 100 shares or less and shall be computed as follows:

• • • •

Rules

Chapter VII, Section 9

(a) Members may transact business on the Exchange for non-members who are members of the National Association of Securities Dealers, Inc., or members of another exchange where the rules of such other exchange permit reciprocal arrangements, for a commission of not less than 60% of the minimum commissions specified in Article XVIII, Section 2, of the Constitution.

(b) Upon specific instructions from any bank or trust company (acting for itself or in some fiduciary capacity), insurance company or investment company (mutual fund) as defined in the Investment Company Act of 1940, members may remit to members of the National Association of Securities Dealers, Inc., an amount not to exceed 40% of the commission received on orders executed on the Exchange for any such institutional customer. Members shall obtain written instructions from all such customers for all such transactions and shall retain such instructions as a part of their permanent customer files. A copy of

the instructions received from banks, trust companies, or insurance companies shall be filed with the Exchange within 20 days after the end of each month during which any such transactions occur.

Midwest Stock Exchange

Rules

Article XXIX, Rule 1

Commissions shall be charged and collected under all circumstances, upon all purchases or sales of securities dealt in upon the Exchange wherein a member, member firm or member corporation acts as an agent and shall, except as in this Article of the Rules provided, be absolutely net and free from any rebate, return, discount or allowance. Any reciprocal arrangement made by any member, member firm or member corporation, or any change or termination of such arrangements, shall be promptly reported to the Exchange in writing and shall be subject to its approval.

• • • •

APPENDIX E

PENDING ACTIONS INVOLVING BROKERAGE PRACTICES OF MUTUAL FUNDS

A. First Circuit

District of Massachusetts

1. *Bass* v. *Gardiner,* Civ. A. No. 67-385-F (January 3, 1967) Complaint ¶¶28-44, 48-49 (The Putnam Growth Fund)

2. *Bassoff* v. *Johnston,* Civ. A. No. 68-277-C (March 29, 1968) Complaint ¶¶16-29 (Scudder, Stevens & Clark Common Stock Fund, Inc.)

3. *Graulich* v. *Johnson,* Civ. A. No. 69-260-C (April 8, 1969) Complaint ¶¶27-43 (Fidelity Capital Fund)

4. *Kauffman* v. *The Putnam Growth Fund, Inc. and Fidelity Trend Fund, Inc.,* Civ. A. No. 71-1407-G, *transfer of part of Kauffman* v. *The Dreyfus Fund, Inc.,* Civ. No. 1348-68 (D.N.J. December 18, 1968) Complaint ¶¶40-44, 56

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6. *Lerman* v. *Johnson,* Civ. A. No. 68-305-F (April 11, 1968) Complaint ¶¶19-25, 28, 31-32 (Fidelity Fund, Inc.)

7. *Lieberman* v. *Werly,* Civ. A. No. 67-127-M (February 2, 1968) Complaint ¶¶8, 11-19 (The George Putnam Fund of Boston)

8. *Lurie* v. *Johnson,* Civ. A. No. 68-399-F (May 13, 1968) Complaint ¶¶19a-25, 28, 31-32 (Puritan Fund, Inc.)

9. *Magida* v. *Band,* Civ. A. No. 68-998-G (November 4, 1968) Complaint ¶¶18-33 (B.C. Morton Fund, Inc.)

10. *Marcus* v. *Devens,* Civ. A. No. 67-41-F (January 12, 1967) Complaint ¶¶11-18 (The Putnam Growth Fund)

11. *Meshnick* v. *Burgin,* Civ. A. No. 67-70-G (January 20, 1967) Complaint ¶¶10-11, 16 (Fidelity Trend Fund)

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14. *Schlusselberg* v. *Colonial Management Associates, Inc.,* Civ. A. No. 71-1052-F, *transfer of* 70 Civ. 2654 HRT (S.D.N.Y. June 18, 1970) Complaint ¶¶19-21, 25-32, 37, 43, 48, 62-64, 66-67, 71, 88(d) (Colonial Equities, Inc.)

15. *Schlusselberg* v. *Werly,* Civ. A. No. 67-824-F, *transfer of* 67 Civ. 94 (S.D.N.Y. January 10, 1967) Complaint ¶¶29-44, 47-48 (Putnam Investors Fund, Inc.)

16. *Shaev* v. *Burgin,* Civ. A. No. 69-15-W (January 3, 1969) Complaint ¶¶28-43 (Fidelity Trend Fund)

17. *Stanley* v. *Carret,* Civ. A. No. 71-494-M, *transfer of* 69 Civ. 3487 (S.D.N.Y. August 7, 1969) Complaint ¶¶8-17 (Pioneer Fund, Inc.)

18. *White* v. *Johnson,* Civ. A. No. 68-128-J, *transfer of* 67 Civ. 97 (S.D.N.Y. January 10, 1967) Complaint ¶¶27-43 (Fidelity Capital Fund)

19. *Zicklin* v. *Burgin,* Civ. A. No. 68-139-J (February 13, 1968) Complaint ¶¶10-11, 16-31 (Dow Theory Investment Fund, Inc.)

B. Second Circuit

Southern District of New York

1. *Berstein* v. *Beatty,* 68 Civ. 1252 (March 28, 1968) Complaint ¶¶15-30 (Affiliated Fund, Inc.)
2. *Blaustein* v. *Goelet,* 69 Civ. 1892 (May 5, 1969) Complaint ¶¶22-37 (Scudder, Stevens & Clark Special Fund)
3. *Dermer* v. *Dunn,* 68 Civ. 865 (February 29, 1968) Complaint ¶¶8, 11-17 (Axe-Houghton Fund B)
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5. *Friedenberg* v. *Bernhard,* 65 Civ. 1769 (June 9, 1965) Complaint ¶¶8-11 (The Lehman Corp.)
6. *Gelman* v. *Blodgett,* 68 Civ. 2230 (May 31, 1968) Complaint ¶¶10, 12, 14-20 (Tri-Continental Financial Corp. and Tri-Continental Corp.)
7. *Gluck* v. *Bell,* 65 Civ. 693 (March 8, 1965) Complaint ¶¶8, 10, 12-15 (Tri-Continental Financial Corp. and Tri-Continental Corp.)

8. *Graulich* v. *Bullock,* 69 Civ. 5395 (December 5, 1969) Complaint ¶¶16-31 (Dividend Shares, Inc.)

9. *Gross* v. *Moses,* 67 Civ. 4186, *consolidation of Gluck* v. *Vance, Sanders & Co., Inc.,* 67 Civ. 4186 (October 27, 1967), *Gross* v. *Cooper,* 68 Civ. 1251 (March 28, 1968), and *Funnell* v. *Moses,* Civ. A. No. 69-733-F (D. Mass. July 8, 1969) Complaint ¶¶14-30 (Massachusetts Investors Trust)

10. *Halpern* v. *Thorndike,* 71 Civ. 3446 (August 3, 1971) Complaint ¶¶29-33 (Ivest Fund, Inc.)

11. *Kauffman* v. *The Dreyfus Fund, Inc. and Manhattan Fund, Inc.,* 71 Civ. 3256, *transfer of part of Kauffman* v. *The Dreyfus Fund, Inc.,* Civ. No. 1348-68 (D.N.J. December 18, 1968) Complaint ¶¶40-44, 56

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14. *Lessac* v. *Godfrey,* 69 Civ. 375 (February 3, 1969) Complaint ¶¶9-13 (Keystone Custodian Fund, Series S-4)

15. *Lifter* v. *Dunn,* 68 Civ. 1373 (April 4, 1968) Complaint ¶¶17-27 (Axe-Houghton Fund B)

16. *Ross* v. *Bernhard,* 65 Civ. 665 (March 4, 1965) Complaint ¶¶8-14 (The Lehman Corp.)

17. *Saminsky* v. *Godfrey,* 68 Civ. 1164 (March 21, 1968) Complaint ¶¶18-35 (Keystone Custodian Fund, Series S-4)

18. *Saminsky* v. *The Keystone Co. of Boston,* 68 Civ. 1163 (March 21, 1968) Complaint ¶¶18-35 (Keystone Custodian Fund, Series S-3)

19. *Saminsky* v. *Neuberger,* 68 Civ. 1470 (April 10, 1968) Complaint ¶¶14-24 (Guardian Mutual Fund, Inc.)

20. *Schlusselberg* v. *The Fund of Funds, Ltd.,* 67 Civ. 100 (January 10, 1967) Complaint ¶¶20-38 (Keystone Custodian Fund, Series S-4)

21. *Schlusselberg* v. *Investors Overseas Services, Ltd., S.A.,* 67 Civ. 101 (January 10, 1967) Complaint ¶¶20-38 (Keystone Custodian Fund, Series S-3)

22. *Schwartz* v. *Anderson,* 68 Civ. 4174 (October 22, 1968) Complaint ¶¶14-29 (Group Securities, Inc.)

23. *Schwartz* v. *Starr,* 65 Civ. 735 (March 11, 1965), *consolidation of Schwartz* v. *Starr* and *Mintz* v. *Starr,* 65 Civ. 1639 (May 27, 1965) Complaint ¶¶6-11, 18-31 (Broad Street Investing Corporation)

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26. *Underberg* v. *Selected American Shares, Inc.,* 71 Civ. 2027 (May 7, 1971) Complaint ¶¶13-26 (Selected American Shares, Inc.)

27. *Waxman* v. *Youngman,* 65 Civ. 684 (March 19, 1965), *consolidation of Waxman* v. *Youngman, Polack* v. *Starr,* 65 Civ. 832 (March 19, 1965), *Greenblum* v. *Investors Planning Corp. of America,* 67 Civ. 96 (January 10, 1967) and *Lieberman* v. *Randolph,* 68 Civ. 248 (November 12, 1968) Complaint ¶¶8-15, 23-32 (National Investors Corporation)

28. *Weiss* v. *Chalker,* 67 Civ. 95 (January 10, 1967), *consolidation of Weiss* v. *Chalker* and *Rittenberg* v. *Chalker,* 18 Civ. 938 (February 1, 1968) Complaint ¶¶21-37 (Fundamental Investors, Inc.)

29. *White* v. *Auerbach,* 67 Civ. 99 (January 10, 1967), *consolidation of White* v. *Auerbach, Weinberger* v. *Manhattan Fund,* 67 Civ. 804 (February 27, 1967), *Tonick* v. *Auerbach,* 67 Civ. 1289 (April 3, 1967) and *Kaminsky* v. *Auerbach,* 67 Civ. 2339 (June 15, 1967) Complaint ¶¶14, 21-37 (Manhattan Fund)

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2. *Gluck* v. *Fletcher,* Civ. No. 69-2017-EC, *transfer of* 69 Civ. 1891 (S D.N.Y. March 5, 1969) Complaint ¶¶20-34 (Comstock Fund, Inc.)

3. *Josephson* v. *Chappellet,* Civ. No. 68-516-HP (March 29, 1968) Complaint ¶¶7-8, 11-18 (American Mutual Fund, Inc.)

4. *Josephson* v. *Cody,* Civ. No. 68-498-HP (March 27, 1968) Complaint ¶¶7-8 (Investment Company of America)

5. *Sklar* v. *Cross,* Civ. No. 69-1836-EC, *transfer of* 69 Civ. 849 (S.D.N.Y. March 3, 1969) Complaint ¶¶8(a), 8(d), 8(h), 8(j), 8(m), 10-14 (Enterprise Fund, Inc.)

F. Tenth Circuit

District of Colorado

1. *Levine* v. *Financial Programs, Inc.,* C-1960, *transfer of* 69 Civ. 1889 (S.D.N.Y. May 5, 1969) Complaint ¶¶18-33 (Financial Industrial Fund, Inc.)

SUPREME COURT, U. S.

MOTION FILED

SEP 24 1971

IN THE

Supreme Court of the United States

OCTOBER TERM, 1971

No. ~~319~~ 71 - 319

EDWARD C. JOHNSON, 2D, EDWARD C. JOHNSON, 3D, FIDELITY MANAGEMENT & RESEARCH COMPANY and THE CROSBY CORPORATION,

Petitioners,

v.

ROSE MOSES, FIDELITY FUND, INC., C. RODGERS BURGIN, GEORGE R. HARDING and GILBERT H. HOOD, JR.,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

MOTION BY THE INVESTMENT COMPANY INSTITUTE FOR LEAVE TO FILE A BRIEF AMICUS CURIAE IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI

BRIEF OF THE INVESTMENT COMPANY INSTITUTE, AMICUS CURIAE, IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI

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September 23, 1971

IN THE

Supreme Court of the United States

OCTOBER TERM, 1971

No.

EDWARD C. JOHNSON, 2D, EDWARD C. JOHNSON, 3D, FIDELITY MANAGEMENT & RESEARCH COMPANY and THE CROSBY CORPORATION,

Petitioners,

v.

ROSE MOSES, FIDELITY FUND, INC., C. RODGERS BURGIN, GEORGE R. HARDING and GILBERT H. HOOD, JR.,

Respondents.

MOTION BY THE INVESTMENT COMPANY INSTITUTE FOR LEAVE TO FILE A BRIEF AMICUS CURIAE IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI

The Investment Company Institute hereby respectfully moves for leave to file the attached brief *amicus curiae* in support of the petition for the issuance of a writ of certiorari. Consent to the filing of this brief has been obtained from counsel for the petitioners and for the respondents Fidelity Fund, Inc., C. Rodgers Burgin, George R. Harding and Gilbert H. Hood, Jr. The consent of counsel for respondent Rose Moses was requested but has been refused.

The Institute is the national trade association of the mutual fund industry. Its membership includes open-end investment companies ("mutual funds") holding approximately 94 per cent of the assets of all open-end investment companies registered with the Securities and Exchange Commission under the Investment Company Act of 1940.

The Institute believes that the mutual fund industry, the 8.5 million public shareholders of its member funds and the public interest would be best served if the uncertainty spawned by the Court of Appeals' decision in this case is resolved. That decision has raised important questions with regard to what, if any, obligation a mutual fund manager has to "recapture" for a fund rebates of minimum brokerage commissions paid by the fund in connection with its portfolio transactions. The decision in the present case importantly affects the daily operation of the entire mutual fund industry.

Wherefore, the Institute requests leave to file the attached brief in support of the petition for a writ of certiorari.

Respectfully submitted,

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IN THE

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FIDELITY MANAGEMENT & RESEARCH COMPANY and
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v.

ROSE MOSES, FIDELITY FUND, INC.,
C. RODGERS BURGIN, GEORGE R. HARDING and
GILBERT H. HOOD, JR.,

Respondents.

BRIEF OF THE INVESTMENT COMPANY INSTITUTE, AMICUS CURIAE, IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI

The Investment Company Institute is the national trade association of the mutual fund industry. Its membership includes open-end investment companies ("mutual funds") holding approximately 94 per cent of the assets of all open-end investment companies registered with the Securities and Exchange Commission under the Investment Company Act of 1940. The Institute urges that there are special and important reasons why this Court should review and rule upon the issues raised by the petition for a writ of certiorari.

REASONS FOR GRANTING THE WRIT

Open-end investment companies in the United States manage approximately $55 billion in assets representing the savings of approximately 8.5 million shareholders. By far the greater part of the assets of the industry are invested in common stocks which are traded on national securities exchanges, principally the New York Stock Exchange. Brokerage commissions in the tens of millions of dollars are paid annually by the mutual fund industry.

In recent years, the suggestion has been made that, notwithstanding the anti-rebate rules prevailing on all of the stock exchanges, it is possible for mutual funds to "recapture" rebates of stock exchange commissions which could be used to offset in part the management fees charged the mutual funds by their managers. These suggestions of rebate possibilities have resulted in widespread litigation in the federal courts and the present case is the first of these to come to trial. The Institute believes that there are more than 50 "recapture" cases now pending in the federal courts of at least six circuits and that the Court of Appeals' decision in this case may have an important bearing upon all of them.

Unfortunately, the decision of the Court of Appeals in the present case has done little to clarify the confusion surrounding the legality of and the duty to "recapture". In fact, it has further clouded the issues by dealing in simplistic terms and upon dubious legal grounds with matters vitally affecting the manner in which large pools of capital should be managed in the best interests of public investors and of the economy as a whole.

The Institute urges that this Court resolve these issues at this time. A definitive statement by this Court could dispel the needless uncertainty which now confronts mutual fund managers as to their duty in connection with stock exchange execution. The Institute believes that the mutual fund industry could function more effectively in the public interest if the important questions involved in the decision below were resolved promptly and conclusively.

Decision now by this Court would forestall the conflict of decisions among the circuits which will almost inevitably result from the litigation of so many similar cases in so many different courts.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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September 23, 1971

SUPREME COURT, U. S.

Supreme Court, U.S.
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ROSE MOSES, FIDELITY FUND, INC., C. RODGERS BURGIN, GEORGE R. HARDING and GILBERT H. HOOD, JR.,

Respondents.

BRIEF OF RESPONDENT ROSE MOSES IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

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IN THE

Supreme Court of the United States

October Term, 1971

No. 71-319

EDWARD C. JOHNSON 2d, EDWARD C. JOHNSON 3d, FIDELITY MANAGEMENT & RESEARCH COMPANY and THE CROSBY CORPORATION,

Petitioners,

v.

ROSE MOSES, FIDELITY FUND, INC., C. RODGERS BURGIN, GEORGE R. HARDING and GILBERT H. HOOD, JR.,

Respondents.

BRIEF OF RESPONDENT ROSE MOSES IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

The petition for certiorari invites this Court to undertake an excursion into legal history. It asks the Court to declare unlawful the recapture of "give-ups"; but give-ups have been abolished since December 1968 (Fdg. 35, A. 13; B. 21).* It also asks the Court to review the standards of "gross misconduct" under former § 36 of the Investment Company Act; but the 1970 amendment of § 36 (G. 39) has

* Abbreviated references are used herein as follows:
"R." refers to the record appendix below; "Fdg." to the findings of the District Court; "Ex." to the separately bound exhibits; "A." to "E." to the Appendices, so designated, of the petition; "F." "G." and "H." to the Appendices, so designated, of this brief.

eliminated the concept of "gross misconduct" from the statute. A determination of the issues presented by the petition could thus have no significant impact on existing law or on future controversies.

The supposed conflict of the decision below with a decision of the Second Circuit (Pet. 27) will be seen to be imaginary. Petitioners' request for a review of the facts of the case (Pet. 28-30) would call for an examination and evaluation of a complex record of more than 5000 pages. The various rulings of the Court of Appeals attacked by the petition will be shown to be correct in all respects.

Opinions Below

The opinion of the Court of Appeals is reported at 445 F. 2d 369, that of the District Court at 316 F. Supp. 31.

Statutes and Regulations Involved

In addition to the statutes and regulations referred to in the petition (p. 3), we annex hereto pertinent parts of the text of §§ 1(b), 2(a) and 10 of the Investment Company Act, as effective during the period involved in this litigation (Appendix F.); § 36 of the same Act as amended in 1970, 84 Stat. 1428 (Appendix G.); and certain stock exchange rules (Appendix H.).

Statement of the Case

A. Jurisdiction and proceedings.

In this stockholder's derivative action commenced on December 5, 1967 (R. 2), the District Court's jurisdiction, based on the Investment Company Act of 1940 (the "Act"),

15 USC §§ 80a-1 et seq., was sustained by both Courts below (A. 44; B. 57) and is not questioned here. After a non-jury trial limited to the issue of liability (B. 2), the District Court for Massachusetts (Wyzanski, C.J.) dismissed the action (A. 1, 60). The First Circuit (per Aldrich, Ch. J.) unanimously reversed to the extent of sustaining petitioners' liability with respect to so-called "NASD recapture"; and it remanded the case for a determination of damages (B.1, 31, 32). That determination has not yet been made.

B. The parties.

Respondent Moses is a stockholder of defendant Fidelity Fund, Inc. (the "Fund"), a mutual fund registered under the Act; she brought this action on behalf of the Fund. The real defendants were the directors of the Fund, including petitioners Johnson 2d and his son, Johnson 3d*; the Fund's investment adviser, petitioner Fidelity Management and Research Company ("FMR"); and the Fund's principal underwriter, petitioner Crosby Corporation ("Crosby"), a wholly owned subsidiary of FMR (Fdgs. 1-7, A. 3-4). FMR and Crosby are sometimes herein collectively called the "Management Company".

FMR managed the affairs of the Fund pursuant to a contract under which the Fund paid it annual advisory fees equal to 0.5% of the Fund's net assets up to $200 million and 0.35% of all additional assets. As of mid-1968, the net assets of the Fund were over $834 million (Fdgs. 2, 3, A. 3-4).

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* The action has been dismissed as to the other appearing directors.

Crosby distributed the shares of the Fund to the public, on a continuous basis, through a country-wide dealer organization. Pursuant to the underwriting contract, the Fund sold its shares to Crosby at their current net asset value. The ultimate purchasers paid an additional sales charge or load of 7½% (subject to volume discounts), of which the dealer received 6% and Crosby 1½%.

The charter of the Fund (R. 5452) forbade it to issue or sell its shares at a price which, after underwriting discounts or commissions, would yield it less than the net asset value of the shares.* This provision, critical to the decision below (B. 7-8), is ignored by petitioners.

C. The divided allegiance of the Fund's fiduciaries.

The Fund had no officers or employees devoted solely to its interests. All of them were also stockholders, officers, directors or employees of the Management Company. Their compensation was paid by the Management Company; the Fund paid them nothing (R. 4077-78, 4244).

Petitioner Johnson 2d was the president and board chairman of the Fund; he was also the president, board chairman and principal voting stockholder of FMR. Petitioner Johnson 3d was at all relevant times a vice-president and, since April 1968, a director of the Fund; he was also a vice-president, director and substantial voting stockholder of FMR. Between them, the Johnsons owned 90% of the voting stock of FMR (R. 4076-77, 4243-44).

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* Paragraph 1 of the charter (R. 5452) provided that—
"in no event shall any shares of Capital Stock of the corporation be issued or sold for a consideration (which shall be net to the corporation after underwriting discounts or commissions) less in amount or value than the net asset value of the shares so issued or sold, * * *."

George Sullivan was the executive vice-president of the Fund. He was also a vice-president and stockholder of FMR as well as the president and a director of Crosby (R. 4076-77).

The firm of Gaston, Snow, Motley & Holt ("Gaston Snow") were counsel for the Fund (R. 4257). Simultaneously they were also counsel for the Management Company (R. 2112). Mr. Caleb Loring, Jr., a member of the firm, was a vice-president and the clerk (secretary) of the Fund; he was also a director, vice-president, secretary and stockholder of FMR (R. 4077).

Thus all officers and employees of the Fund as well as its counsel were under dual allegiance to the Management Company.

In these circumstances, the Fund's protection against managerial overreaching depended on those of its directors who were not affiliated with the Management Company. As required by §§ 10(a) and 10(b)(2) of the Act (F. 37-38), a majority of the Fund directors were unaffiliated. Petitioners, however, intentionally withheld from the unaffiliated directors vital information necessary for the discharge of their functions; petitioners thereby enabled themselves to profit at the expense of the Fund. It is this conduct of petitioners which is the major basis of the decision below (B. 28-29).

D. Petitioners' give-up practices.

The Management Company's compensation from the Fund depended, in large measure, on the number of Fund shares sold to the public. Increased stock sales swelled Crosby's sales charges; they also enhanced the size of the

Fund and, with it, the advisory fees of FMR. Petitioners thus had a vital interest in stimulating the sales of the Fund's shares.

The volume of these sales depended on the efforts of the dealers whom Crosby used to sell the shares. It was Crosby's responsibility to pay the dealers. Their contractual compensation was a portion of Crosby's sales charge. Crosby seized upon a method to provide extra rewards for the dealers, but not from its own resources. It used the Fund's portfolio brokerage business, and the commissions generated thereby, to discharge its own responsibility.

The means were basically simple. The Fund bought and sold great amounts of portfolio securities on the New York and regional stock exchanges ("portfolio transactions"). The Fund's brokerage commissions added up to large sums —more than $6 million in 1967 (R. 4248). So attractive was the Fund's portfolio business to the executing brokers that they were willing to surrender a substantial part of their commissions. Direct commission rebates to the Fund were forbidden by the minimum commission and anti-rebate rules of the constitutions of the several exchanges (B. 3; see D. 1 et seq.). The exchange rules, however, permitted executing brokers to "give up", i.e., to pay parts of their commission to other brokers or dealers designated by the customer. These "customer-directed give-ups" (herein called "give-ups") could be directed to brokers or dealers who had no part whatever in the portfolio transactions which gave rise to the commission.

At the behest of the Management Company, the Fund directed give-ups to those dealers who sold the shares of the Fund to the public (B. 3-4). More than one-third of the

Fund's brokerage commissions ($2,116,498 in 1967) was used in this fashion (R. 4421). As a result, the dealers' contractual compensation (6% of the offering price of the shares) was augmented to 7%, 8% or more (R. 1996-97). Crosby was relieved of any need to pay this extra dealer compensation from its own resources.

The SEC had long been critical of give-ups which did not inure to the benefit of the funds and their shareholders (pp. 9-10, below). In response to SEC pressure, the exchanges finally issued a flat prohibition of all customer-directed give-ups effective December 5, 1968 (Fdg. 35, A.13; B. 21; R. 3755). See *Independent Broker-Dealers' Trade Ass'n* v. *SEC*, 442 F. 2d 132 (D.C. Cir. 1971), *cert. den.* U.S. (No. 70-232, Oct. 12, 1971).

E. The possibility of recapturing give-ups for the Fund.

The give-ups, generated by the Fund's commission payments but used by petitioners for their own benefit, could instead have been channeled back to the Fund. As will be seen, such "recapture" by the Fund could have been effected lawfully and in complete harmony with all applicable stock exchange rules. The SEC repeatedly and emphatically supported recapture. Rulings of the very stock exchanges concerned with recapture sanctioned it. The uncontradicted testimony of two witnesses expert in stock exchange practices, including the expert called by petitioners themselves, vouched for the propriety of recapture. The Court below sustained it. Petitioners alone dissent, but their views simply reflect their self-interest; for by denying recapture to the Fund they enabled themselves to use the give-ups to their own advantage.

1. *Recapture through Pacific Exchange membership.*

In early 1965, subsidiaries of the management companies of four large mutual fund complexes secured membership on the Pacific Coast Stock Exchange ("Pacific Exchange"). These subsidiaries executed the portfolio transactions of the funds at the prevailing commission rates or received give-ups from the brokers who executed the transactions. The management companies, in turn, applied all or part of their subsidiaries' brokerage profits from commissions and give-ups to reduce the advisory fees payable by the funds. The funds thus recaptured part of their brokerage expenses through the reduction of their advisory fees. (See pp. 109-10, 172-73 of the SEC Report identified at p. 9, below.)

This recapture method, based on the acquisition of exchange membership by a management company affiliate, will be called "exchange recapture".

2. *NASD recapture; the SEC hearings of 1965 and 1966.*

Exchange recapture was not the only available recapture method. Several regional exchanges, including the Philadelphia-Baltimore-Washington Stock Exchange ("PBW Exchange"), permitted their members to pay give-ups to non-exchange members, provided that the recipients were members of the National Association of Securities Dealers ("NASD") (D. 3-5). Similarly, the Pacific Exchange permitted give-ups to NASD members who became "preferred rate" or "approved non-members" of Pacific; that status was available to all NASD members upon payment of a nominal fee (D. 9-10, 13-14).

Petitioner Crosby was a member of NASD (R. 4075). Accordingly, PBW and Pacific Exchange give-ups generated by the Fund's portfolio commission business could

have been directed to Crosby, followed by a corresponding reduction of the advisory fees payable by the Fund to FMR. This recapture method is herein called "NASD recapture".

On June 3, 1965, the staff of the SEC conducted a hearing (Fdg. 65, A. 23) attended by officers of the Management Company and a law partner of Gaston Snow, Mr. Loring's firm. The SEC officials "suggested that Crosby, though not an exchange member, could receive give-ups through its NASD membership, which could then be set off against the advisory fee" (B. 14). The Management representatives raised various objections, but did not suggest that NASD recapture might be contrary to the exchange anti-rebate rules (B. 14-16).

A year later, on September 23, 1966, the SEC staff conducted another hearing (Fdg. 67, A. 24) attended by the same Management representatives. The SEC officials again suggested, indeed urged, that the Fund should recapture through Crosby (B. 15-16; R. 2209-18). The Management representatives admitted, upon question, that nothing had been done about recapture since the previous hearing (B. 16). Again they did not suggest the supposed illegality of recapture under the anti-rebate rules (*ibid.*).

3. *The SEC's Public Policy Report.*

About two months after this hearing, on December 2, 1966, the SEC issued its *Report on the Public Policy Implications of Investment Company Growth*, 89th Cong., 2d Sess., H.R. 2337 (Ex. 6, herein called "PPI"). The SEC criticized the use of give-ups for the benefit of adviser-underwriters rather than the fund shareholders (PPI 172):

> "Although the commissions are generated by fund portfolio transactions and are paid by the funds,

> their use as extra compensation for sales of fund shares benefits the adviser-underwriters and the retail sellers of fund shares rather than fund shareholders."

The SEC then referred to the exchange recapture effected by the four mutual fund complexes on the Pacific Exchange (PPI 109-10, 172-73) and suggested widespread emulation in the interest of affording greater protection to fund shareholders (PPI 173):

> "Widespread emulation by institutional investors of the precedent set by these four complexes could have a marked effect on the economics of the securities industry. Within the framework of the existing commission rate structure it is a method whereby mutual fund shareholders can derive greater benefits than they have heretofore received from fund brokerage commissions."

The SEC further stated that its views similarly applied to NASD recapture (PPI 173):

> "It would not be inconsistent with those [regional exchange] rules for dealer-distributed funds to direct give-ups to their adviser-underwriters, all of whom are NASD members, for the purpose of applying these give-ups to reduce the advisory fees payable by the funds."

The SEC was thus clearly aware of the "existing commission rate structure" (PPI 173), including minimum commission and anti-rebate rules, but made it plain that it found no conflict between those rules and any type of recapture.

4. *The recapture ruling of the PBW Exchange.*

The correctness of the SEC's interpretation of the regional exchange rules was confirmed by a ruling of the PBW Exchange of December 14, 1967, which expressly sanctioned NASD recapture by a mutual fund. The fund (called Pro Fund, Inc.) was permitted to direct a PBW member (Cannon) to give up 40% of its fund-generated commissions to the fund's NASD adviser-underwriter; the latter would credit the give-ups against the advisory fees of the fund (Fdg. 71, A. 24-25; B 21; see R. 1927).

Mr. Wetherill, the president of PBW, later testified that *any* NASD adviser-underwriter was free to accept give-ups of this kind and to apply them against the advisory fees of mutual funds under its management (R. 1876-77, 1887). He further made it plain that the ruling in the Pro Fund case was no innovation, but reflected what had always been the policy of the PBW Exchange (R. 1881-82, 1887).

5. *The Reilly report.*

Following the commencement of this action in December 1967 and a further SEC release pressing for recapture (R. 3740),* the Gaston Snow firm, counsel for the Fund and the Management Company, undertook an investigation of all recapture possibilities on the regional exchanges. Mr. Reilly, an associate of the firm, visited the regional exchanges and conferred with their leading executives (R. 2508-09). His detailed report of March 25, 1968 (R. 3976) concluded that recapture appeared possible on every major regional exchange (R. 4005):

> "From the above outline it seems that on each of the leading regional exchanges it is possible, through

* Release No. 8239 of January 26, 1968 (R. 3740).

techniques varying from direct to indirect, for a mutual fund to either execute a transaction at less cost or to receive credit against expenses for a portion of commissions paid."

6. *The recapture ruling of the Pacific Exchange.*

Petitioners did not accept Reilly's findings but, after waiting two months, asked the Pacific Exchange for "definitive answers" whether NASD recapture was indeed permissible despite the anti-rebate rules (R. 4040, 4052-53). On July 25, 1968, after thorough deliberation (R. 4059), the Exchange's president, Mr. Phelan, confirmed the advice previously given to Mr. Reilly (R. 4061-62): In the case of the four fund complexes, the anti-rebate rule had been interpreted as not precluding exchange recapture. The same interpretation, Mr. Phelan ruled, was applicable to NASD recapture (R. 4061-62):

> "We have interpreted this provision [of the Pacific Exchange's anti-rebate rule] as not precluding any of our members receiving 'give-ups' from adjusting the management fees for funds they manage to a degree proportionate to the amount of the 'give-ups' received, and the same interpretation would be applicable to preferred rate firms."
>
> • • •
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> "The Exchange does not purport to exercise any control over the management fee charged by [FMR] or the adjustment of fees by virtue of its increased earnings from 'give-ups' received by [Crosby], its wholly-owned subsidiary."

Crosby thereupon became a preferred rate or approved non-member of the Pacific Exchange (R. 840).

7. *The Fund's tardy recapture.*

Despite the SEC's repeated warnings in 1965 and 1966, petitioners took no *ante litem* steps to effect recapture or even to test its possibility. Even after the commencement of this action on December 5, 1967, petitioners waited nearly a year before recapturing any PBW or Pacific give-ups for the Fund. In May and July 1968 FMR instructed its PBW and Pacific brokers to "bank" their give-ups, that is, to hold them until further direction (Fdgs. 78, 79, A. 27). Finally, on November 27, 1968, counsel advised the unaffiliated directors of the Fund that they must decide in their best judgment whether or not to recapture the "banked" give-ups (R. 4529). The directors thereupon voted to recapture them (R. 4526-28), and the banked give-ups were in fact recaptured by the Fund (R. 823, 842).

8. *The expert testimony.*

The common feature of exchange recapture and NASD recapture was that a fund's portfolio commissions, or the give-ups generated thereby, were applied in reduction of the advisory fees of the fund. The uncontradicted expert testimony demonstrates that such a fee reduction was not in conflict with the exchange anti-rebate rules.

Mr. Robert M. Bishop, vice-president of the New York Stock Exchange ("NYSE") in charge of the enforcement of its minimum commission rates (R. 4289-91), testified (R. 4387-88):

> "Q. Now, let's assume that a member firm is an investment adviser on an open end investment company and intends to execute orders for that open end investment company.

"A. Do you mean it has the investment management contract?

"Q. Correct. Can it reduce its advisory fee in an amount which is equivalent to the commissions that it receives for executing the Fund orders?

"A. Yes.

"Q. That is not a rebate?

"A. No."

Faced with this testimony, petitioners took the deposition of Mr. Donald Calvin, another vice-president of the NYSE and member of the bar, whose duties included all Exchange dealings with the SEC (R. 5019-20, 5024). Mr. Calvin testified (R. 5107):

"Q. And it would be permissible, would it not, for a member acting as an investment adviser, or member organization acting as an investment adviser, to a Mutual Fund to provide that its advisory fee be reduced in accordance with commissions received on portfolio transactions of the Fund, is that right?"

"A. My understanding is that that is correct."

The witnesses thus agreed that an adviser-underwriter, upon receiving the fund's portfolio commissions (or commission give-ups), is free to allow a corresponding reduction of the fund's advisory fees. Such a fee reduction is not a forbidden rebate and is, therefore, a lawful and proper vehicle for recapture of commissions or commission give-ups by the fund.

The testimony, to be sure, related to the anti-rebate rule of the NYSE; but since that rule is the "prototype" of the corresponding regional exchange rules (A. 51; Pet. 5, n. 6), the expert testimony of Mr. Bishop and Mr. Calvin powerfully supports the rulings of the PBW and Pacific Exchange officials sanctioning the NASD recapture of fund-generated commission give-ups through credits against the fund's advisory fees.

F. Petitioners' misconduct: concealment of available recapture possibilities from the Fund's unaffiliated directors.

1. Petitioners' supression of recapture information.

Petititoners have been found grossly derelict in failing to inform the Fund's unaffiliated directors of the SEC's repeatedly expressed views in favor of NASD recapture (B. 28). It is now undisputed that, under the charter of the Fund (p. 4, above), the recapture of give-ups, if practicable, was mandatory (B. 7-8). Petitioners' self-interest, however, was intensely opposed to recapture; every give-up dollar recaptured by the Fund became unavailable to stimulate the fund-selling dealers and, hence, could not boost petitioners' compensation. Only the unaffiliated directors, under the guidance of independent counsel, could have formed an unbiased judgment on the practicability of recapture.

Petitioners prevented the unaffiliated directors from exercising that judgment and from seeking the recapture mandated by the Fund's charter. The Court below found, and it is undisputed, that petitioners were familiar with the SEC's repeated recapture suggestions (B. 27-28). Equally undisputed here is the finding below that petitioners withheld this information from the unaffiliated directors (B. 14-22, 27-28). Even after the institution of this action forcibly brought recapture to the attention of the directors did petitioners persist in their policy of secretiveness. Reilly's finding that NASD recapture was readily available on both the PBW and Pacific Exchanges (R. 3984, 3999) was kept by petitioners from the unaffiliated directors, on the transparent plea that "they might not see the forest for the trees" (B. 20-21; R. 883-84, 955-58, 1080).

Johnson 2d, Loring and Sullivan compounded the suppression of Reilly's findings by downright misrepresentations. At the Fund's board meeting of March 28, 1968, Sullivan, in the presence of Johnson and Loring, told the directors that counsel (i.e., Mr. Reilly), having visited all the major regional exchanges, "had concluded that the anti-rebate rules of all these regional exchanges appeared to prevent any recapture by the Fund" (see the board minutes of May 29, 1968, R. 3397-98, summarizing the board proceedings of March 28, 1968). In fact, Reilly had reached the opposite conclusion, that recapture seemed possible on each of the leading regional exchanges (R. 4005).*

2. *Petitioners' alleged reliance on counsel.*

Petitioners' claimed excuse that they acted in good faith and on the advice of counsel has not been sustained by either Court below. It flies against the overwhelming weight of the evidence.

None of petitioners claims to have consulted counsel after the first SEC hearing of June 1965. After the second hearing of September 1966, Johnson 2d talked to Loring; but Loring, as the owner of 18,500 FMR shares (R. 884) and as dual officer and counsel of the Fund and FMR, was not the man to give unprejudiced legal advice on matters involving a conflict of interests between FMR and the Fund. Even so, Loring told Johnson 2d no more than that NASD recapture "would pose a problem because of the anti-rebate

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* Petitioners have attempted to dispute the accuracy of the quoted May 29 minutes, but Mr. McKenzie, one of the unaffiliated directors, confirmed it (R. 1537-38). The May 29 minutes were signed by Loring (R. 3402), and they were approved by all the directors, including Johnson and Sullivan, at the next board meeting of June 27, 1968 (R. 3403).

rules" (R. 718) and that he thought it "improbable" that recapture could be effected by these methods (R. 719). Johnson 2d was clearly aware that he was not getting a legal opinion which might exculpate him.* Neither petitioners nor their counsel bothered, prior to this action, to inquire from any of the regional exchanges whether NASD recapture, as urged by the SEC, was feasible (R. 906). Upon these facts, petitioners' claim that "counsel investigated the available materials relevant to any NASD recapture" (Pet. 28) is patently unfounded; the Court of Appeals was right in holding (B. 16):

> "'Investigation' seems a palpable exaggeration of what was done. All the record shows is that they [the Management defendants] discussed it among themselves."

There is even less substance to petitioners' alleged reliance upon statements made by Mr. Loomis and Mr. Phillips, General Counsel and Assistant General Counsel of the SEC, at the Mutual Funds Conference held at the University of Pennsylvania Law School in February 1967 (Pet. 11; Ex. 1-K, Attachment, 115 U.Pa.L. Rev. 835, 853). The state-

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* Johnson 2d testified (R. 176-77):

> "The Court. • • • we are all aware that sometimes clients seek, and for good reason and perfectly honorably, to have the protection of a lawyer's opinion. • • • Ordinarily somebody who wishes to take advantage of that kind of exculpatory provision in the statute or an exculpatory provision implied in the common law or the law of trusts would put a formal question and get a formal answer from his detached, informal (sic) lawyer. As I understand it, you did not try to take advantage of any such exculpatory mechanism but you, on the contrary, made what could be called a rather informal inquiry and got a rather informal answer.
>
> "The Witness. I think that is fair."

ments, read in context, merely suggested that, so long as the stock exchange rules permitted give-ups, funds could be expected to "do something with these commissions" rather than wasting them. Neither Mr. Loomis nor Mr. Phillips so much as hinted that recapture was impossible or illegal; and it is preposterous to suggest that SEC counsel meant to contradict the recapture views expressed by the SEC itself only two months before in its PPI Report.

Most important, petitioners themselves do not claim that they were advised by counsel to keep the recapture information from the unaffiliated directors. Petitioners knew that the government agency charged by Congress with the administration of the Securities Exchange Act and the Investment Company Act favored recapture and deemed it consistent with the rules of the stock exchanges. Whatever contrary legal advice petitioners might have received, they were thus "on full notice that the possibility of recapture was a substantial issue that directly involved their self-interest" (B. 27). In these circumstances, it was sheer arrogance for petitioners to take the resolution of the issue into their hands and to resolve it in favor of their own aggrandizement, to the exclusion of the unaffiliated directors, who were by law appointed as the "watch-dog directors" of the Fund (B. 13). It was petitioners' failure to disclose the possibility of any NASD recapture to the unaffiliated directors which the Court below branded as "gross misconduct" (B. 28). Petitioners can and do point to no evidence that counsel ever encouraged their blatant disregard of the unaffiliated directors.

REASONS FOR DENYING THE WRIT

POINT I

The Court of Appeals properly sustained the legality of NASD recapture.

Petitioners contend that NASD recapture violated the minimum commission and anti-rebate rules* of the PBW and Pacific Exchanges. It also violated, they say, the anti-trust laws. Neither contention has merit.

A. Recapture did not violate the anti-rebate rules.

The Court below sustained NASD recapture. The SEC urged it. The PBW and Pacific Exchanges sanctioned it. The expert witnesses vouched for it. Only petitioners contend, but without even an attempt at analysis, that the "scheme" was "patently" a forbidden rebate (Pet. 7, 18-22).

1. Petitioners' fundamental error is their conception of the anti-rebate rules as providing "that every customer would pay identical commissions" (Pet. 21). Petitioners misread the rules. The prescribed commission rates were and are *minimum* commissions.** Brokers could charge more, and they often did. Customers' charges were thus by no means uniform.

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* For brevity, we shall sometimes refer to these rules collectively as "anti-rebate rules".

** See PBW Const. Art. XX, § 1 (D. 2-3):

> "* * * commissions shall be at rates *not less than* the rates in this article prescribed; and they shall be absolutely net and free from any rebate, * * *". (Emphasis added.)

To the same effect are NYSE Const. Art XV, § 1 (D. 1), and Pacific Const. Art. XIV, § 1 (D. 7-8).

Differential charges frequently arose in connection with a broker's investment advice to his customers. Brokers were not required to make an extra charge for their investment advice; the minimum commission included compensation for the advice.* But since the commissions were *minimum* commissions, brokers were free if they chose (and if the customers agreed) to charge an advisory fee in addition to the commission. So long as the brokers received the minimum commission, nothing in the anti-rebate rules either required or forbade an additional advisory fee.

Since it was a matter of indifference under the exchange rules whether the extra advisory fee was large or small or zero, the broker was also free to reduce the fee in proportion to the volume of the customer's commission business. In other words, he could reduce the fee by the amount of the commissions. This was frequent practice; see the SEC's PPI Report (Exh. 6, pp. 108-9):

> "The use of brokerage commissions to pay for investment advisory services is common in the securities industry. Investment advisers who are also broker-dealers often reduce advisory fees charged nonfund clients by a specified portion of the brokerage commissions generated by their nonfund advisory accounts or otherwise take them into account in setting advisory fee rates for non-fund clients."

Nothing in this practice contravened the anti-rebate rules; for despite the reduction or even the elimination of the advisory fee, the customer still paid the prescribed

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* See the SEC's PPI report (Ex. 6, p. 109):
"* * * the level of the minimum commission rates of the national securities exchanges is affected by the fact that brokerage commissions compensate brokers not only for execution and clearing services but for investment advice and other services customarily provided without extra charge."

minimum commission rates. The mathematical operation of the practice is illustrated in the margin.*

An exchange member acting as adviser-underwriter of a mutual fund was in no different position. He could execute the fund's portfolio transactions at the prescribed minimum commission rates; or he could receive give-ups from the executing brokers. In either case he was free to reduce the fund's advisory fee by the amount of the commissions or give-ups. The expert witnesses, Mr. Bishop and Mr. Calvin, testified that such a fee reduction was not a forbidden rebate (pp. 13-14, above), and they were clearly right; for while the fee was reduced or eliminated, the fund still paid the minimum commissions.

The same principle supported the propriety of NASD recapture on the PBW and Pacific Exchanges. The fund paid the prescribed minimum commissions to the PBW or Pacific brokers executing its portfolio transactions. The fund's adviser-underwriter, as NASD member, shared in these commissions through give-ups; and it reduced the fund's advisory fee by the amount of the give-ups. Again this fee reduction was not a forbidden rebate; for so long as the fund paid the minimum commissions, the presence

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* Suppose that, over a period of time, a customer had incurred minimum commissions of $100,000. His investment advisory fee for the same period was $120,000. If the fee was reduced by the amount of the commissions, the customer paid his broker a net amount of $120,000 ($100,000 as commissions and $20,000 as the balance of the fee). Since this was more than the minimum commissions, the anti-rebate rule was satisfied.

Or suppose that the minimum commissions were $100,000, while the advisory fee was only $80,000. If the commissions were applied against the advisory fee, the fee was eliminated; but the customer still had to pay the minimum commission of $100,000. Again the anti-rebate rule was satisfied.

or absence of any additional fee charges was of no concern to the Exchanges.* NASD recapture was thus wholly consistent with the anti-rebate rules.

2. The rulings of the PBW and Pacific Exchanges sustaining NASD recapture (pp. 11, 12, above) lend added, indeed decisive weight to this conclusion. It is elementary that the interpretation of an administrative regulation by the agency issuing it has "controlling weight unless it is plainly erroneous or inconsistent with the regulation"; *Udall* v. *Tallman*, 380 U.S. 1, 16-17 (1965). The PBW and Pacific Exchanges had adopted their anti-rebate rules as part of the self-regulation authorized by §§ 6 and 19 of the Securities Exchange Act (C. 3-8); see *Silver* v. *New York Stock Exchange*, 373 U.S. 341, 352-53 (1963). The interpretation by these Exchanges of their own rules is thus entitled to no less credit than th interpretation of any administrative regulation by the a[illegible]ncy adopting it. Since the interpretation of the PBW and Pacific anti-rebate rules by the Exchanges was, to say the least, a permissible one, the Court of Appeals rightly gave it controlling weight (B. 22-25).

Petitioners suggest that the Exchange rulings should be ignored because they were issued by the presidents of the Exchanges rather than the boards of governors (Pet. 21, 22). While it is true that only the boards of governors could issue "final and conclusive" interpretations of the Exchange rules,** the presidents were charged with the "duty

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* As the PBW and Pacific Exchange officials put it, the Exchanges had "no jurisdiction" or "control" over the advisory fee paid by the fund to its investment adviser (R. 1876-77, 4061-62).

** PBW Const. Art. III, § 21; Pacific Const. Art. XVIII, § 2 (H. 42, 43).

to enforce the provisions of the constitution and rules".* The power to enforce necessarily included the power to interpret. Petitioners themselves addressed their requests for interpretation to the presidents of the two Exchanges (R. 4019, 4050) and did not see fit to appeal the presidents' determinations to the boards of governors.

Petitioners' contention that all other regional exchanges forbade NASD recapture as an illegal rebate (Pet. 18) is not supported by the authority they cite (Fdg. 41, A. 14), and it is flatly contradicted by their own assertion that the Detroit and Boston Exchanges permit "the equivalent of NASD Recapture" (Pet. 34). In any event, each Exchange was, of course, competent to interpret only its own rules.

3. On petitioners' premise that NASD recapture was a forbidden rebate, they argue that the Exchanges could permit recapture only by filing a new rule with the SEC. Recapture was, however, wholly consistent with the anti-rebate rules, so that there was neither need nor room for a separate recapture rule.

B. Recapture did not violate the antitrust laws.

Neither Court below found recapture to be in conflict with the antitrust laws. Petitioners' assertion of such a conflict—which they barely adumbrated below (B. 23, n. 19)—is altogether insubstantial.

1. Petitioners would have it that NASD recapture was a " 'split-level' discriminatory price-fixing scheme", under which other investors paid the minimum commissions while investment companies paid less (Pet. 18). As previously

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* Pacific Const. Art. III, § 4(b); PBW Const. Art. VII, § 1 (H. 42, 43).

shown, however, recapture did not relieve a mutual fund from paying the minimum commissions. It reduced only the amount of the extra advisory fees which mutual funds, like other customers, voluntarily paid in addition to the minimum commissions. Those extra fees were not "price-fixed"; they were negotiated between broker and client from case to case. Competition among brokers in respect of the advisory fees was thus completely unrestrained.

What is more, the practice of reducing advisory fees in proportion to the volume of a customer's commission business was "common in the securities industry" and was often employed in favor of "nonfund clients" (PPI Report 108-9, quoted at p. 20, above). Petitioners' charge of discrimination in favor of mutual funds thus stands the truth on its head.

2. According to petitioners, the PBW and Pacific Exchanges unlawfully restricted NASD recapture to mutual funds; for under the Exchange rules only investment funds could direct give-ups to non-exchange members who were members of NASD (Pet. 18, n. 17). Petitioners omit to mention that they themselves directed substantial amounts of PBW and Pacific give-ups to NASD dealers who sold the shares of the fund (R. 1941-43). If the Exchange rules permitting such give-ups were discriminatory, as petitioners claim, it was thus petitioners who violated the antitrust laws. The violation would not have been aggravated if petitioners, instead of using the give-ups to their own advantage, had directed them to Crosby with a view to reducing the Fund's advisory fees. The Court below so held (B. 23, n. 19). Certainly petitioners, as fiduciaries, cannot claim that the give-up benefits "should be put in their own

pockets, because they were unlawful gains, for fear that the conscience of the cestui que trust should be defiled by a participation in them. To indulge trustees in such an obliquity of conscience would be holding out immunity for misconduct''; *Barney* v. *Saunders,* 57 U.S. (16 How.) 535, 543 (1853).

3. The posture of this case hardly invites review of petitioners' antitrust argument by this Court. The perpetrators of the supposed discriminatory scheme—i.e., the Stock Exchanges and their members—are not before the Court. Nor does any investor claim to have been victimized by the supposed discrimination. The issue is raised, instead, by fiduciaries who contend that they could not do their duty because they might have incurred antitrust sanctions. The Court of Appeals rejected the defense (B. 23, n. 19), and this Court should not, in the absence of the parties directly concerned, review antitrust problems presented in such oblique and hypothetical fashion.

POINT II

The Court of Appeals properly found petitioners guilty of gross misconduct under former § 36 of the Investment Company Act.

Section 36 of the Act, prior to its 1970 amendment, authorized the SEC to bring suit for the ouster of fund fiduciaries guilty of ''gross misconduct'' (C. 2). The Court below held, and it is now undisputed, that gross misconduct also furnished the basis for a private right of action under the Act (B. 5-6).

Petitioners argue that the Court of Appeals, in finding them guilty of gross misconduct, applied erroneous legal standards and made unwarranted findings of fact. Both contentions are unfounded.

A. The Court of Appeals applied proper legal standards.

Section 36 does not define "gross misconduct", but other provisions of the Act as well as its legislative history provide helpful guidance.

1. Section 1(b)(2) of the Act (F. 36-37) declares that "the national public interest and the interest of investors are adversely affected"—

> "2. When investment companies are organized, operated, managed * * * in the interest of directors, officers, investment advisers * * * rather than in the interest of all classes of such companies' security holders; * * *."

This language is amplified by a canon of statutory interpretation set forth in the concluding sentence of § 1(b):

> "It is hereby declared that the policy and purposes of this title, *in accordance with which the provisions of this title shall be interpreted,* are to mitigate and, so far as is feasible, to eliminate the conditions enumerated in this section which adversely affect the national public interest and the interest of investors." (Emphasis added)

The policy of the Act thus requires the investment adviser and directors of an investment company to manage it solely in the interest of the company, to the exclusion of their own interests. The term "gross misconduct" in § 36 must be interpreted in accordance with this policy. A merely negli-

gent breach of duty is not gross misconduct. Petitioners, however, operated the Fund's commission give-ups in their own interest rather than in the interest of the Fund. This is the very type of misconduct which § 1(b)(2) condemns and which the Act was designed to prevent. To exclude such misconduct from the sweep of § 36 would nullify the purpose of the Act and defeat the canon of interpretation of § 1(b).

The legislative history of § 36 confirms this analysis. Section 36 is derived from § 17(e) of the bill originally proposed by the SEC (S. 3580, 76th Cong., 3rd Sess.), which provided criminal sanctions for "gross misconduct". Mr. David Schenker, counsel for the SEC, explained that this term was chosen in order to preclude criminal liability for mere negligence; *Hearings on S. 3580 before Subcommittee of the Senate Committee on Banking and Currency,* 76th Cong., 3rd Sess., 1940, p. 262. The pursuit by fund fiduciaries, such as petitioners, of private gain at the expense of the fund thus falls squarely within § 36. *Greene, Fiduciary Standards of Conduct under the Investment Company Act of 1940,* 28 Geo. Wash. L. Rev. 266, 270, n. 12 (1959); *Eisenberg and Lehr, Directorial Responsibility under the Investment Company Act of 1940,* 20 Rutgers L. Rev. 181, 203 (1966).*

Aldred Inv. Trust v. *SEC,* 151 F. 2d 254, 260 (1st Cir. 1946), cert. den. 326 U.S. 795, affirmed a finding of gross

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* Petitioners' contention that the legislative history equates gross misconduct with "shocking abuse" (Pet. 25, n. 26) is a flagrant distortion. Petitioners' claimed source (*Senate Committee Hearings, supra,* p. 40) has nothing whatever to do with § 36 or its predecessor, but is a narrative statement that the SEC's investigation of investment companies had uncovered many "shocking abuses".

misconduct because the defendants had "been using their control of other people's money to enrich themselves through the perquisites of such control." This language fits precisely the present petitioners' conduct. Equally apposite is the concurring opinion (151 F. 2d at 261):

> "In view of the declaration of policy set forth in the Act in question it appears that the term 'gross abuse of trust', as used therein, covers a course of conduct by the officers and controlling stockholders of an investment company in violation of the standards of conduct generally applied to fiduciaries, such as would exist if they were acting with other than disinterested motives."

Accord: *Brown* v. *Bullock,* 194 F. Supp. 207, 237-245 (S.D.N.Y.), *aff'd en banc,* 294 F. 2d 415 (2d Cir. 1961).

2. In order to mitigate the danger of self-dealing on the part of fund management, § 10 of the Act (F. 37-38) requires a majority of the fund directors to be unaffiliated with, i.e., independent from the adviser-underwriter.*

Section 10 was enacted to protect fund shareholders from exploitation by insiders with conflicting interests; *National Ass'n of Securities Dealers* v. *SEC,* 420 F. 2d 83, 92 (D.C. Cir. 1969), rev'd on other grounds sub nom. *Investment Company Institute* v. *Camp,* 401 U.S. 617 (1971). The unaffiliated directors cannot perform their function as "watchdog directors" (B. 13) without full and fair information about the affairs of the Fund; and since only management

---

* Forty percent of the directors must be unaffiliated with the investment adviser; a majority must be unaffiliated with the underwriter, §§ 10(a) and 10(b)(2). A director controlled by the adviser-underwriter is deemed affiliated with him; § 2(a)(3)(C) of the Act (F. 37).

can furnish that information, it is management's duty to supply it. *Imperial Financial Services, Inc.*, '64-'66 CCH Fed. Sec. L. Rep. ¶ 77,287, at p. 82,464 (SEC 1965):

> "The Investment Company Act requirement as to unaffiliated directors, if its purposes are not to be subverted, carries with it the obligation on the part of the affiliated directors, and the investment adviser itself, to insure that unaffiliated directors are furnished with sufficient information so as to enable them to participate effectively in the management of the investment company."

Indeed, the policy of the Act requires the imposition of this duty on management. Section 1(b)(1) of the Act declares that it is "contrary to the national public interest in the interest of investors" when investors are "without adequate, accurate and explicit information, fairly presented, concerning * * * the circumstances, [and] policies * * * of such [investment] companies and their management" (F. 36). The same requirement of full and fair information must apply to the unaffiliated directors, who are the eyes and ears of the investors.

Again, § 36 of the Act must be interpreted in accordance with this statutory purpose and policy. The need for action by the unaffiliated directors is particularly urgent in areas where the management of the fund is subject to conflicting interests. Management's duty to inform the unaffiliated directors becomes then imperative. To exclude a knowing violation of that duty by management from the reach of § 36 would frustrate the statutory schemes and policies.

In the present case, petitioners knew as early as 1965 and 1966 that the SEC approved and, indeed, urged NASD recapture. Petitioners had a direct selfish interest in pre-

venting recapture by the Fund. They did prevent it by withholding the SEC's views from the unaffiliated directors. Their deliberate and contemptuous disregard of the unaffiliated directors flagrantly manifested itself after the commencement of this action: Petitioners concealed from the directors the finding of their own counsel, Mr. Reilly, that NASD recapture was readily available on the PBW and Pacific Exchanges (B. 20-21); and they compounded this nondisclosure by the affirmative falsehood of telling the directors that counsel had found recapture to be impossible on all major regional exchanges (p. 16, above). As a result of petitioners' conduct, the give-up dollars which should have gone to the Fund were used for petitioners' benefit. Petitioners' conduct flouted the purposes and policies of the Act. It was nothing less than gross misconduct.

***The decision below is not in conflict with the Second Circuit's decision in* Rosenfeld v. Black.**

The Court below held it unnecessary to decide whether a breach of duty less than gross is a sufficient basis of fiduciary liability under the Act (B. 5-6). *Rosenfeld* v. *Black*, 445 F. 2d 1337, 1342-46 (2d Cir. 1971), has since answered the question in the affirmative. Petitioners are not aggrieved because they were judged by a standard more lenient than that of *Rosenfeld*.

Petitioners invoke the Second Circuit's statement that gross misconduct means "highly reprehensible conduct" (445 F. 2d at 1346), but that phrase plainly fits petitioners, who used their fiduciary powers to enrich themselves at the expense of the Fund. It is thus hardly necessary to add that the quoted phrase was mere dictum, since the *Rosenfeld*

defendants were found liable even though their misconduct was not held to be "gross".

B. The findings of fact of the Court of Appeals were in accord with the overwhelming weight of the evidence.

1. Contrary to petitioners' assertion (Pet. 28), the Court of Appeals was clearly aware of its limited functions as finder of facts and guided itself accordingly (B. 5, n. 6). FRCP 52(a) authorized the Court to set aside findings of the District Court which were clearly erroneous and to make opposite findings required by the great weight of the evidence.*

2. According to petitioners, the Court below overlooked that they allegedly acted in good faith and pursuant to the advice of counsel; but actually the Court considered and overruled the defense (B. 16). The flimsy nature of the defense has been discussed (pp. 16-18, above). Petitioners do not dispute that they knew the SEC's recapture views; even if counsel advised them differently, the issue was plain; it was their duty to report it to the unaffiliated directors, since it involved a head-on conflict of interests between petitioners and the Fund. Petitioners themselves do not contend that anybody advised them that it was unnecessary to inform the unaffiliated directors.

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* Thus in *U.S.* v. *U.S. Gypsum Co.*, 333 U.S. 364, 393-400 (1948), this Court overruled, as clearly erroneous, the district court's finding that the defendants had not engaged in an antitrust conspiracy and found affirmatively the existence of a conspiracy. For other instances of appellate findings opposite to those of the district court, see, e.g., *U.S.* v. *Singer Mfg. Co.*, 374 U.S. 174, 194, n. 9 (1963); *J. Gerber & Co.* v. *S. S. Sabine Howaldt*, 437 F. 2d 580, 588 (2d Cir. 1971); *Smith* v. *Sol D. Adler R. Co.*, 436 F. 2d 344, 350 (7th Cir. 1970).

3. Petitioners contend that at least Johnson 3d should be exonerated because he did not become a Fund director until April 1968. The point was not raised in the Court below. Although petitioners' brief below (pp. 90-91) devoted a separate section to the issue of "gross misconduct", the name of Johnson 3d was not once mentioned throughout the brief. He cannot now claim differential treatment since he did not seek it below.

In any event, the record fully establishes his liability. At least since 1962, and throughout the years involved in this litigation, he was a vice president of the Fund as well as FMR (R. 4077) and owned 29% of FMR's stock (R. 2905). He testified that it was his responsibility as officer of the Fund "to observe the overall operation, to see that the Fund is run—to the best of our ability—in the best interests of the Fund shareholders" (R. 2903-04). Certainly this responsibility included a duty to inform the unaffiliated directors of policy issues involving a conflict of interests between the Fund and FMR. Johnson 3d knew of the recapture views expressed by the SEC at the hearings of 1965 and 1966; he discussed them with his father, Johnson 2d; but he did not inform the unaffiliated directors (R. 2934-35, 2956-60). His misconduct, which inured to his profit as stockholder of FMR, was no less gross than that of the other petitioners.

POINT III

The issues raised by the petition do not warrant review by this Court.

1. Petitioners would have this Court decide whether NASD recapture violated the exchange anti-rebate rules or the antitrust laws. With the abolition of give-ups in Decem-

ber 1968, the possibility of NASD recapture has become a matter of the past. The issue thus lacks public importance, if it ever had any.

Petitioners contend that "[t]he equivalent of NASD recapture" is still available on various regional exchanges (Pet. 33-34). The assertion, if true,* would only confirm the consensus of all regional exchanges that recapture does not infringe the anti-rebate rules. So far as the antitrust laws are concerned, petitioners themselves do not maintain that the supposed "equivalent to NASD Recapture" involves discrimination in favor of mutual funds; petitioners' antitrust argument, based on discrimination, is therefore inapplicable.

2. According to petitioners, "issues similar or identical to those at bar" are raised in some fifty currently pending actions (Pet. 31). The number is highly exaggerated; many of the cases overlap (involving as they do identical fund families); some have been settled. None of them has produced a decision at variance with that of the First Circuit below. In the absence of an inter-circuit conflict, the mere pendency of cases supposedly similar to that at bar hardly affords a ground for granting the writ. See this Court's Rule 19(1)(b).

3. The petition suggests that the Court below laid down an absolute fiduciary duty of fund managements to effect

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* Petitioners speak of a "discount" available to NASD members under various regional exchange rules (Pet. 34, n. 40). Mutual funds are not members of NASD; petitioners do not explain how mutual funds can enjoy the discounts. If a method could be devised of "passing the discount on to mutual funds" (*ibid.*), it would be equally available to nonfund customers. Obviously the present case is not the place to explore the antitrust incidents of hypothetical recapture methods whose operation has not been developed by the evidence.

recapture whenever it is feasible (Pet. 12, 31-32, 34). Actually the Court below merely held that *the Fund's charter* rendered recapture mandatory (B. 7-8); the Court imposed liability because petitioners knowingly withheld the SEC's recapture views from the unaffiliated directors. Other fund cases may involve no comparable charter provision or no similarly secretive conduct on the part of management. The scope of the decision below is too narrow to invite review by this Court.

4. The finding below that petitioners were guilty of "gross misconduct" under old § 36 of the Investment Company Act can have no substantial effect as a precedent. As noted, the 1970 amendment of § 36 has eliminated the term "gross misconduct" from the statute (G. 39-41).

There is no conflict between the decision below and the Second Circuit's dictum in *Rosenfeld* v. *Black, supra* (445 F. 2d 1337, 1346), that gross misconduct must be "highly reprehensible" (pp. 30-31, above). The Court below refrained from listing synonyms for the phrase "gross misconduct"; but there can be no doubt that petitioners' conduct, in using their fiduciary powers to enrich themselves at the expense of the Fund, was "highly reprehensible".

CONCLUSION

The petition for a writ of certiorari should be denied.

Dated: October 29, 1971.

Respectfully submitted,

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APPENDIX F

Excerpts from §§ 1(b), 2(a) and 10(a) and (b) of the Investment Company Act of 1940 prior to its 1970 amendment.

Section 1(b)

(b) Upon the basis of facts disclosed by the record and reports of the Securities and Exchange Commission made pursuant to section 30 of the Public Utility Holding Company Act of 1935, and facts otherwise disclosed and ascertained, it is hereby declared that the national public interest and the interest of investors are adversely affected—

(1) when investors purchase, pay for, exchange, receive dividends upon, vote, refrain from voting, sell, or surrender securities issued by investment companies without adequate, accurate, and explicit information, fairly presented, concerning the character of such securities and the circumstances, policies, and financial responsibility of such companies and their management;

(2) when investment companies are organized, operated, managed, or their portfolio securities are selected, in the interest of directors, officers, investment advisers, depositors, or other affiliated persons thereof, in the interest of underwriters, brokers, or dealers, in the interest of special classes of their security holders, or in the interest of other investment companies or persons engaged in other lines of business, rather than in the interest of all classes of such companies' security holders;

* * * * *

Appendix F

It is hereby declared that the policy and purposes of this title, in accordance with which the provisions of this title shall be interpreted, are to mitigate and, so far as is feasible, to eliminate the conditions enumerated in this section which adversely affect the national public interest and the interest of investors.

Section 2(a)

GENERAL DEFINITIONS

SEC. 2. (a) When used in this title, unless the context otherwise requires—

* * * * *

(3) "Affiliated person" of another person means (A) any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding voting securities of such other person; (B) any person 5 per centum or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person; (C) any person directly or indirectly controlling, controlled by, or under common control with, such other person; (D) any officer, director, partner, copartner, or employee of such other person; (E) if such other person is an investment company, any investment adviser thereof or any member of an advisory board thereof; and (F) if such other person is an unincorporated investment company not having a board of directors, the depositor thereof.

Section 10

SEC. 10. (a) After one year from the effective date of this title, no registered investment company shall have a board of directors more than 60 per centum of the members

of which are persons who are investment advisers of, affiliated persons of an investment adviser of, or officers or employees of, such registered company.

(b) After one year from the effective date of this title, no registered investment company shall—

* * * * *

(2) use as a principal underwriter of securities issued by it any director, officer, or employee of such registered company or any person of which any such director, officer, or employee is an affiliated person, unless a majority of the board of directors of such registered company shall be persons who are not such principal underwriters or affiliated persons of any of such principal underwriters;

* * * * * *

APPENDIX G

Section 36 of the Investment Company Act of 1940, as amended December 14, 1970 (84 Stat. 1428).

(a) The Commission is authorized to bring an action in the proper district court of the United States, or in the United States court of any territory or other place subject to the jurisdiction of the United States, alleging that a person serving or acting in one or more of the following capacities has engaged within five years of the commencement of the action or is about to engage in any act or practice constituting a breach of fiduciary duty involving personal misconduct in respect of any registered investment company for which such person so serves or acts—

(1) as officer, director, member of any advisory board, investment adviser, or depositor; or

(2) as principal underwriter, if such registered company is an open-end company, unit investment trust, or face-amount certificate company.

If such allegations are established, the court may enjoin such persons from acting in any or all such capacities either permanently or temporarily and award such injunctive or other relief against such person as may be reasonable and appropriate in the circumstances, having due regard to the protection of investors and to the effectuation of the policies declared in section 1(b) of this title.

(b) For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the

security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person. With respect to any such action the following provisions shall apply:

(1) It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and the plaintiff shall have the burden of proving a breach of fiduciary duty.

(2) In any such action approval by the board of directors of such investment company of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, and ratification or approval of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, by the shareholders of such investment company, shall be given such consideration by the court as is deemed appropriate under all the circumstances.

(3) No such action shall be brought or maintained against any person other than the recipient of such compensation or payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments. No award of damages shall be recoverable for any period prior to one year before the action was

instituted. Any award of damages against such recipient shall be limited to the actual damages resulting from the breach of fiduciary duty and shall in no event exceed the amount of compensation or payments received from such investment company, or the security holders thereof, by such recipient.

(4) This subsection shall not apply to compensation or payments made in connection with transactions subject to section 17 of this title, or rules, regulations, or orders thereunder, or to sales loans for the acquisition of any security issued by a registered investment company.

(5) Any action pursuant to this subsection may be brought only in an appropriate district court of the United States.

(6) No finding by a court with respect to a breach of fiduciary duty under this subsection shall be made a basis (A) for a finding of a violation of this title for the purposes of sections 9 and 49 of this title, section 15 of the Securities Exchange Act of 1934, or section 203 of title II of this Act, or (B) for an injunction to prohibit any person from serving in any of the capacities enumerated in subsection (a) of this section.

APPENDIX H

Stock Exchange Regulations

PACIFIC COAST STOCK EXCHANGE

Constitution

Article III, Section 4:

Sec. 4(b). The President shall be the principal executive officer of the Exchange, and it shall be his duty to enforce the provisions of the Constitution and Rules and to foster the general interests of the Exchange.

Article XVIII, Section 2:

Sec. 2. The Constitution shall be interpreted when necessary by the Board of Governors, which interpretation shall be final.

Appendix H

PHILADELPHIA-BALTIMORE-WASHINGTON STOCK EXCHANGE

Constitution

Article III, Section 21:

Sec. 21. The Board of Governors shall have power to interpret the Constitution of the Exchange and the rules adopted pursuant thereto. Any interpretation made by it shall be final and conclusive.

Article VII, Section 1:

Sec. 1. The President shall be the principal executive officer of the Exchange and the office shall be his principal occupation to which he shall devote his full time. He need not be a member of the Exchange. He shall have general care of the interests of the Exchange and shall be responsible for the management and administration of its affairs. It shall be his duty to uphold and enforce the Constitution and Rules of the Exchange.

REPLY BRIEF OF THE PETITIONER

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1971

No. 71-319

EDWARD C. JOHNSON 2d, EDWARD C. JOHNSON 3d, FIDELITY MANAGEMENT & RESEARCH COMPANY and THE CROSBY CORPORATION

Petitioners

v.

ROSE MOSES, FIDELITY FUND, INC., C. RODGERS BURGIN, GEORGE R. HARDING and GILBERT H. HOOD, JR.

Respondents

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

REPLY BRIEF FOR PETITIONERS

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In The

Supreme Court of the United States

October Term, 1971

No. 71-319

EDWARD C. JOHNSON 2d, *et al.*
Petitioners

v.

ROSE MOSES, *et al.*
Respondents

On Petition for Writ of Certiorari to the
United States Court of Appeals
for the First Circuit

REPLY BRIEF FOR PETITIONERS

The Respondent Moses ("Respondent") seeks to support the judgment of the Court of Appeals largely on grounds other than those on which the Court of Appeals itself decided the case. As we shall develop, this is further evidence of the weakness of the decision below and the need for this Court's review.

I. As to the Illegality of NASD Recapture

The Court of Appeals admitted the obvious — that NASD Recapture was a "rebate." (B.24-25) However, the Court of Appeals held that since the PBW and Pacific Exchanges as a matter of practice "chose to permit it," the practice was not unlawful and Petitioners were under a duty to embrace it. (B.25) We contended that, beirg in fiat

contravention of the Exchanges' antirebate rules, NASD Recapture violated the Securities Exchange Act and could not enjoy any shelter from that Act against illegality under the Sherman Act. (PET. 18-25)

1. In a repetition of an argument made to the Court of Appeals (APPT's BR. 52-65 and REP. BR. 27-40) and quite properly ignored even by that court, Respondent now urges that NASD Recapture was not a rebate at all. (BR. OP. 19-23) The argument, baldly stated, is that there was no rebate because instead of being paid to the fund in cash, the "recaptured" commissions were simply to be credited by the fund's management company against an amount otherwise owing it by the fund — the advisory fee.

Extended discussion should hardly be necessary to refute this notion. Clearly, a rebate may be given either in cash or by offsetting accounts. A rebate was in fact paid to the fund under the NASD Recapture scheme although instead of the fund being paid in cash, it was given credit against money which it otherwise unquestionably owed, its advisory fee to the management company — an advisory fee which was here stipulated by all parties to be reasonable in amount. (R.4072) A rebate is a rebate, as both the Court of Appeals (B.24-25) and District Court (A.51) found here, whether given in cash or credit; whether given "by any method or arrangement, direct or indirect." (PBW CONST., art. XX, § 1, D.3).

To a great extent Respondent's argument proceeds from a false analogy to the New York Stock Exchange's Rule 440A. That rule permits NYSE member stockbrokers to reduce the charges they make to clients for certain advisory publications and services by the amount of commissions on their accounts. See Appendix I. The theory behind the rule is that the commission itself includes conventional

"broker's research" (F.60, A.22) and that an advisory fee paid to a broker can be reduced to the extent it is paid for such "research" so as to avoid duplication of charges. (See Br. Op. 20) In the first place, it should be noted that this practice was covered by a published rule of that Exchange.[1] Moreover, as the District Court found, Rule 440A permits brokers to reduce their advisory fees only by the value of conventional broker's literature — publications and printed services. (F.60, A.22) The Court of Appeals did not disturb this finding.

Most fundamentally, the fact that Respondent's advisory fee crediting argument, based on NYSE Rule 440A, is a red herring follows from the point that, of course, Crosby was not a stockbroker. Crosby did no brokerage business; it was not and could not be an exchange member; it neither bought nor sold portfolio securities for the Fund. (F.56-60, A.19-22) In NASD Recapture, its sole function was to serve as a conduit for the rebating of fund brokerage to the Fund. On the other hand, the brokers who actually executed the Fund's transactions on the regional exchanges did not serve

[1] There is much talk in the Brief in Opposition about "expert witnesses" "vouching for" NASD Recapture. (Br. Op. 13-14, 19, 21) What the cited passages of the record have to do with is the testimony of NYSE officials as to its practice under Rule 440A permitting brokers *who were also investment advisers* to make a reduction in their fees for statistical and investment advisory services in accordance with commissions generated. (R.4369-70, 5099-5102) This is evident even from the passages quoted at Br. Op. 14, which discuss NYSE member firms, who of course must be stockbrokers, reducing their advisory fees. The testimony had nothing to do with NASD Recapture. It must be remembered that the case was tried in the District Court not only on charges that the Fund should have engaged in NASD Recapture earlier than it did, but also on charges that it should have formed a brokerage subsidiary or affiliated itself with a stockbroker, and thus achieve "exchange recapture". The District Court rejected this latter contention (F.45-64, A.16-23, 52-53) and the Court of Appeals affirmed. (B.8-10)

as the Fund's adviser, either directly or through an affiliate.[2] NASD Recapture did not involve a stockbroker reducing its advisory fees to a client by reason of the client's commission business. Rather it was a device by which stockbrokers, who were not the Fund's investment adviser and who were owed no advisory fees, passed a share of their commissions on to a conduit, like Crosby, for rebate to the Fund.

Moreover, despite Respondent, neither the PBW nor the Pacific Exchange officials who tolerated NASD Recapture did so on the basis of Respondent's theory. Mr. Wetherill, the president of PBW, simply testified that his exchange had no jurisdiction over Crosby or what it did with the give-ups it received. (R.1881-83) That, of course, would allow Crosby to pay the cash directly back to the Fund customer; and Respondent's counsel so admitted in closing argument in the District Court. TRANSCRIPT, July 20, 1970, p. 154.[3] On Pacific, the Application for Preferred Rates of

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[2] This distinguishes the similar false analogy which Respondent somewhat gingerly introduces in the Brief in Opposition — Pacific Exchange membership. (BR. OP. 8) As we pointed out in the Petition, Pacific Exchange membership was never available to the Fidelity group and the Pacific Exchange changed its rules in 1965 to prevent any repetition of the situation in which four "direct-selling" fund groups had affiliates join that Exchange. (PET. 9 n.10)

[3] The following colloquy occurred during the closing argument:

"[RESPONDENT'S COUNSEL]: [Mr. Wetherill] said that this policy had always been the policy of the Exchange. It did not represent a new policy. The Exchange had no jurisdiction over what the NASD member did with the give-ups.

"THE COURT: You mean if the member gave it directly to the customer?

"[RESPONDENT'S COUNSEL]: Presumably that would have been permitted also because, according to Mr. Wetherill, there was no jurisdiction over what the NASD member did with the give-up money that he received."

Commission which a fund distributor had to sign in order to receive the preferred rate of commission (which Respondent claims can be passed on to the Fund) contained a solemn promise that "the applicant [i.e., Crosby] will charge customers [i.e., the Fund] . . . not less than the minimum public rates of commission as established by said Exchange. The applicant will not directly or indirectly extend or grant the Preferred Commission Rate to another not approved by the Exchange to receive such rate". (D.17) The indications that crediting was permissible were simply lawless views on the part of two exchange officials which reflect a refusal to enforce the exchanges' antirebate rules.

Respondent's entire argument that NASD Recapture was not a rebate and therefore legal accordingly fails. Respondent argues (Br. Op. 23) that since NASD Recapture was not a rebate and, hence, not inconsistent with the antirebate rules, the regional exchanges did not have to cover it with a filing with the SEC under the Exchange Act. The trouble is that no one has ever claimed, apart from Respondent, that NASD Recapture was not a rebate. The SEC staff member who threw it out as a suggestion at the 1965 meeting with Fidelity characterized it as "a rebate of commissions." (F.65, A.23) The District Court and the Court of Appeals held it was a rebate. (A.51; B.24)

2. Equally unavailing is Respondent's argument that there was no antitrust violation inherent in NASD Recapture.[4] Respondent contends (Br. Op. 23-25) that NASD Recapture did not involve a split-level commission system

[4] Respondent suggests that this case is an inappropriate one in which to determine whether NASD Recapture involved an antitrust violation. (Br. Op. 25) But it has always been undisputed in this case that if NASD Recapture was unlawful, Petitioners had no obligation either to engage in it or to tell the other directors of the Fund about it. (B.22) Since it has always been the Petitioners' position that NASD Recapture was unlawful be-

under which some customers of brokers would pay one level of commissions and others would pay a lower level, but simply involved competition among brokers who were also investment advisers, the competition being evidenced by reduced advisory fees. Since neither FMR, Crosby, nor anyone else in the FMR organization was a stockbroker, it is impossible to follow this argument. Once again, Respondent attempts to obfuscate the issues as to NASD Recapture by using some of the evidence which was adduced in her unsuccessful effort to show that the Fund should have affiliated itself with a stockbroker. NASD Recapture involved funds whose advisory organizations were *not* engaged in the brokerage business. Under NASD Recapture, only mutual funds could have achieved reduced commissions.[5] (See PET. 18 & n.17)

II. As to the Finding of Gross Misconduct Under Section 36 of the Act

1. Respondent makes no serious effort to deny that the standard of "guilt" of "gross misconduct" laid down by the Court below (see PET. 27) was completely in conflict with

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cause, among other things, of the antitrust laws, it certainly is not "oblique" or "hypothetical" (BR. OP. 25) to pass on the issue before holding them liable.

[5] Respondent also argues in passing that if NASD Recapture violated the antitrust laws, so did the direction of give-ups by funds to unaffiliated dealers who were engaged in selling shares of the fund. (BR. OP. 24) Respondent neglects to mention the fact that give-ups, directed at the instance of mutual funds, were expressly sanctioned by filed rules of the exchanges, to the extent that they did not violate the anti-rebate rules which were also filed. (PET. 22-23 n.24) Moreover, these customer-directed give-ups to other brokers simply broadened the category of brokers who were sharing in the fund's commissions (R.4506), and did not involve a return of commissions to the funds with the consequence of a split-level discriminatory commission system.

that enunciated by the Second Circuit in *Rosenfeld* v. *Black*, 445 F.2d 1337, 1342-46 (2d Cir. 1971). However, Respondent attempts to dismiss the conflict by saying that under the *Rosenfeld* decision, Petitioners might still have been held liable — as it was held that the defendants in *Rosenfeld* could be — for civil damages other than through a finding of "guilt" of "gross misconduct" under Section 36 of the Act. (Br. Op. 30-31)

Respondent thus asserts that Petitioners are not wronged by being branded with "guilt" of "gross misconduct" under the extraordinary standard laid down by the First Circuit because some other court might still have found them pecuniarily liable without imposing that stigma on them. This hardly detracts from the necessity of this Court's review. *Cf. Cole* v. *Arkansas*, 333 U.S. 196 (1948). The damage to Petitioners' reputations through their conviction by the Court of Appeals of "guilt" of "gross misconduct" still remains. Moreover, it is sheer speculation whether the Court of Appeals for the First Circuit would have found civil liability in this case otherwise than for "guilt" of "gross misconduct" under Section 36. The District Court was of the opinion that Section 36 was the sole source of civil liability in the federal courts in the case at bar (A.45-46); the Court of Appeals did not disagree (B.5-6); liability was founded solely on a conviction of "gross misconduct."

Here again, the fact that Respondent finds it necessary to seek to uphold the Court of Appeals' judgment on a ground other than that on which it was rendered underscores the need for this Court's review.

2. In an effort to suggest that Petitioners were properly found "guilty" of "gross misconduct," Respondent not only

suppresses certain facts but also affirmatively misstates others.

(a) Respondent claims that "the SEC repeatedly and emphatically supported" NASD Recapture. (Br. Op. 7) The only authorities cited are the remarks of the SEC staff members — who neither spoke for the Commission nor explained how NASD Recapture could be squared with the antirebate rules[6] — in the 1965 and 1966 hearings, and the single sentence quoted from the PPI Report. (Br. Op. 8-10) Respondent suggests that the SEC in the PPI Report found NASD Recapture to be consistent with the antirebate rules. (Br. Op. 10) However, when one quotes (as we did, Pet. 9-10, and as Respondent did not) the preceding sentence in the PPI Report, it is plain that all that is being talked about are the give-up rules and that no consideration is being given to the antirebate rules.

Despite Respondent's implications (*e.g.*, Br. Op. 5-7), the use of customer-directed give-ups to stimulate sale of Fund shares was not a private scheme concocted by the Petitioners.[7] It was, rather, a general industry practice, openly followed, which arose from the fixed minimum commission system and the fact that the antirebate rules prohibited paying the commissions back to the funds. (R.4857-58) The Fidelity group, like the industry generally (PPI, p. 184 n.114), described the practice in annually updated prospectuses

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[6] The SEC staff member who first brought it up called NASD Recapture a "rebate." (Pet. 8)

[7] The release of January 26, 1968 (R.3740-52) simply *proposed* a rule (10b-10), a rule which would have operated only *prospectively* had it been adopted, and *it never was adopted*. The Court of Appeals condemned the Petitioners *retroactively* for not pursuing a course that no one at the time was pursuing.

(F.114, A.39-41) and in annual proxy statements (F.93, A.32-33), which were reviewed by the SEC, without challenge from that agency.[c]

This is underscored by the remarks of SEC General Counsel Loomis and his assistant Phillips, at the University of Pennsylvania Mutual Funds Conference, that fund managers, in using customer-directed give-ups to encourage sales of fund shares, were not "in any way delinquent." These remarks were made immediately following a reference to the PPI NASD Recapture suggestion. Compare p. 835 with p. 834, 115 U. Pa. L. Rev., No. 5 (March 1967),

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[c] Respondent consumes much space in attacking Petitioners for allegedly "enriching themselves" by directing give-ups of Fund brokerage to reward sales. But the substantial benefits the Petitioners obtained for the Fund at the expense of sales reciprocals belie the charges that NASD Recapture was not taken up with the Board for fear that sales might be injured. The District Court found that in obtaining best execution on Fund portfolio transactions the Fidelity group used the Third Market (where there is no fixed minimum commission schedule) *far more than any other mutual fund* thereby achieving a savings on trades in that market of approximately 40% compared to the standard stock exchange commissions. (F.21-22, A.8-9) The Fund never directed give-ups on the Third Market (R.1197, 1504; see PPI, p. 178) and leading Third Market dealers did not sell Fund shares (see R.4519, 5397). For the years 1966-1968, by their extensive use of the Third Market, the Petitioners achieved commission savings for Fidelity Fund of approximately $1,000,000 and for the Fidelity group overall of approximately $5,350,000, all at the expense of sales reciprocal. At all relevant times "exchange recapture" would have involved the loss of far more sales reciprocal than NASD Recapture (see R.3743); yet the Petitioners put the item of the Pacific memberships on the agenda for a meeting of the unaffiliated directors as early as January 27, 1966 (R.4846, 710-11). One would hardly inform the directors of this grand scale approach to "recapture" while concealing from them the NASD Recapture device which, when in full-scale operation later in 1968 produced only $18,428 in about seven months on PBW (R.823) and $22,312 in about four months on Pacific (R.842).

Ex. 1-K, att. 1. In view of these remarks, what it is "preposterous to suggest" (*cf.* Br. Op. 18) is that the single sentence in PPI represented an official SEC position that NASD Recapture was a course which mutual fund managements would be derelict in not pursuing.

Despite the Respondent's numerous references to the SEC's supposedly positive views as to NASD Recapture, the fact of the matter remains that the SEC's only definitive action with respect to NASD Recapture was to instigate the exchanges to abolish customer-directed give-ups upon which it depended. See Pet. 14.

(b) Respondent never addresses herself to the question how Petitioners could be "guilty" of "gross misconduct" in not earlier practicing NASD Recapture when, out of more than four hundred mutual funds in the country, they were the first to engage in it on the Pacific Exchange and the second on the PBW Exchange. (See Pet. 14, 26, 31) For the Court of Appeals to have found Petitioners guilty of "gross misconduct" because of an alleged tardiness when they were the pioneers among the industry is to condemn the entire industry with the same finding. Certainly this is a circumstance indicating the necessity of this Court's review.

(c) In an effort to suggest consciousness of wrong-doing by the Petitioners and thus to bring them within the established interpretation of Section 36 — not that enunciated below — Respondent's principal device is her story about the Reilly memorandum. (Br. Op. 11-12, 15-16, 30) The memorandum was prepared in March, 1968 by an attorney with Gaston Snow, counsel for the Fund, after a series of interviews with officials of the various regional exchanges; its background is discussed at Pet. 12-13. Here again, Respondent engages in selective quotation. Directly follow-

ing the sentence quoted by Respondent (Br. Op. 11-12), the memorandum concluded: "It must be emphasized that the conclusions as reported above are tentative at best. It is to be expected that before definitive decisions would be made, the Boards of Governors of the various exchanges will be consulted to determine policy and it is likely that the exchanges may delay decisions until the present confusion in the area has settled and certain patterns have emerged." (R.4005-06) Reilly next recommended the submission of "detailed letters" to each exchange, asking for rulings as to the permissibility of the techniques for recapture. He noted that: "With the exception of Philadelphia [referring to the Pro Fund letter], none of the exchanges have ever taken official positions on the issues . . . . It is probably safe to say that none of the exchanges, including Philadelphia, has thought through all the problems [e.g., the problems created by the antirebate rules]." (R.4006)

What was told the board of directors about Reilly's memorandum at its March 28, 1968 meeting was exactly the true state of the dilemma facing the Fund: namely, that while the published rules of the various exchanges all forbade NASD Recapture, it appeared that on certain of the regional exchanges officials might be willing to tolerate or wink at it. Despite Respondent's assertions (Br. Op. 16), what Sullivan (in the presence of Johnson and Loring) reported to the board, as stated in the minutes of the meeting at which the report was made, was: "that counsel had concluded that, in view of the anti-rebate provisions which are contained in the constitutions of all of these exchanges and the apparent inconsistency of the effect of certain rules and their interpretation with such anti-rebate provisions, answers to comprehensive written presentations made to each exchange would be necessary before any definite advice by counsel could be given." Minutes of March 28, 1968

MEETING, R.3385. This was a fair summary of counsel's position as set forth in the Reilly memorandum (R.3976-4008) and particularly in its conclusions (R.4005-08). (F.99, A.34-35) Respondent's charges of "downright misrepresentations," "deliberate and contemptuous disregard of the unaffiliated directors," and "affirmative falsehood" (BR. OP. 16, 30) are false and reckless.[9]

III. THE IMPORTANCE OF THE QUESTIONS

In our petition, we listed, with citations to the pertinent paragraphs of the complaints, a total of 57 cases pending in the federal courts raising issues similar or identical to those at bar. (PET. 31, E.1 to E.7) Respondent states: "The number is highly exaggerated." (BR. OP. 33) Strangely, no details as to the exaggeration are given. Respondent does not deny the authenticity of her counsel's reported statement, quoted in the petition, "that there are about 50 other suits swinging on this give-up decision." (PET. 31)

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[9] Respondent, dealing with the embarrassing point that Johnson 3d was a bystander in the events as to which he was held "guilty" of "gross misconduct," claims that we cannot urge this point because "the name of Johnson 3d was not once mentioned throughout the brief" below of the Petitioners. (BR. OP. 32) Since he had been found blameless by the District Court (A.46), and had been referred to by the appellant in her brief only to identify him (APPT'S BR. 4), there was nothing for the appellee to reply to and no occasion to mention him. The reason for this general lack of mention of Johnson 3d below was that he had nothing to do with the matters charged in the complaint. The failure to mention him hardly seems a reason to find him guilty. Respondent claims that Johnson 3d was shown by the record to have known of "the recapture views expressed by the SEC [*sic*] at the hearings of 1965 and 1966" and to have discussed them with his father. (BR. OP. 32) However, the record references cited make it plain that what Johnson 3d discussed with his father was possible "exchange recapture." He was not shown to have any specific knowledge about NASD Recapture.

Respondent also claims that some of the 57 suits "have been settled." Again we are not provided with any supporting details for this assertion. The only suit on the list of 57 as to which we are aware of a settlement is case number B-9 listed on page E-4 of the petition, *Gross* v. *Moses*, where a settlement was approved after the petition was filed.[10] That leaves 56 cases. Respondent also says that somehow the number of cases is exaggerated because of a so-called "overlap" since some of them involve "identical fund families." Whatever Respondent means, the fact remains that (disregarding the *Gross* case which has been settled) the cases which we listed in our petition involve funds accounting, as of December 31, 1970, for net assets of more than $22 billion, according to the 1971 edition of Wiesenberger on Investment Companies. It is hard to deny the importance of cases involving close to half of the entire investment company industry.[11]

Respondent also dwells on the fact that Section 36 of the Act was amended in 1970 to eliminate the term "gross misconduct." (Br. Op. 34) But as we set forth in the petition (Pet. 31-33), the pending cases involve conduct before the amendment to the Act and, accordingly, must be judged under the terms of Section 36 as it stood at the time. Moreover, as we also pointed out (Pet. 32 n.36), a decision as to

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[10] We referred to the proposed settlement of *Gross* in our Petition. See Pet. 34.

[11] As of the same date, the total assets of the industry amounted to approximately $54 billion. Investment Companies 13 (Arthur Wiesenberger Services ed. 1971). However, approximately $9 billion of the industry's assets were accounted for by the four fund complexes which achieved Pacific Exchange membership. NASD Recapture is not relevant to these four complexes (p. 4 n.2, *supra*) and they are not involved in the pending litigation.

the meaning of pre-amendment Section 36 would furnish guidelines for the interpretation of the revised Section 36(a) of the Act.

In a final argument bordering on the absurd, Respondent (notwithstanding the public assertion of her counsel which we reported in the petition (PET. 31)) now claims that this case is unique since, it is said, it turns on a peculiarity in Fidelity Fund's charter. (BR. OP. 33-34; see also BR. OP. 4) That is the provision of the charter that the Fund was not to issue its stock for less than its net asset value. (R.5452) The implicit suggestion that the other mutual funds in the country are free to engage in selling their stock for less than net asset value is ludicrous. It is a fundamental fact of the industry that all mutual fund shares are sold at no less than net asset value, net of any applicable sales charges. See PPI, pp. 51, 204. The prospectuses of all mutual funds so state (see, *e.g.*, R.3685, 3588, 3618, 4780, 2737, 4616); and the Investment Company Act ordains that sales of fund shares must be made at the price set forth in the prospectus. See § 22(d) of the Act, 15 U.S.C. § 80a-22(d); see also Rule 22c-1 under the Act, 17 C.F.R. § 270.22c-1 ("net asset value"). If Fidelity Fund were obligated somehow to engage in NASD Recapture in order to obtain "net asset value" for its shares, then all other mutual funds were so obligated. It is, accordingly, idle to deny, as does Respondent, that the court below "laid down an absolute fiduciary duty of fund managements to effect [NASD] recapture." (BR. OP. 33-34) The SEC has not interpreted the decision below as simply applicable to those funds which have language similar to Fidelity Fund's language in their charters. See SEC Memorandum in Opposition to Proposed Settlement of *Gross* v. *Moses*, 67 Civ. 4186, S.D.N.Y., pp. 9-11 (August 1971). Neither did Respondent's counsel

when he admitted that some 50 pending cases in the courts all "swing" on the decision below.

With over 50 cases in the lower federal courts dependent upon this case, our petition hardly is an invitation to an "excursion into legal history." (Br. Op. 1) Moreover, as we pointed out in the petition, and as appears to be undenied, the equivalent of NASD Recapture is still available on a number of regional exchanges.[12] (Pet. 33-34) A decision in this case will thus be of crucial importance to the mutual fund industry even apart from its impact on pending litigation.

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[12] As to our statement that the availability of "discounts" to NASD members which exist under certain present regional exchange rules could result in a rebate to mutual funds, Respondent says: "Mutual funds are not members of NASD; petitioners do not explain how mutual funds can enjoy the discounts." (Br. Op. 33 n.) Let us hasten to explain. They would enjoy them the same way that Respondent contends the funds should have enjoyed NASD Recapture: by the fund's distributor, which is a member of the NASD, passing the discount on to the fund.

CONCLUSION

For the reasons stated in the petition and in this reply brief, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX I

NYSE Rule 440A

CCH NYSE Guide, ¶ 2440A

.10 *To whom furnished.* — A member or member organization may furnish:

(1) To a professional non-member (i.e., broker-dealer in securities or commodities, insurance company, investment advisor, investment manager, bank, trust company, foundation, professional trustee, or one engaged in any closely allied activity), statistical and investment advisory services:

(A) Prepared by the member or member organization; or

(B) prepared by others and reissued by the member or member organization in his or its own name with the consent of the original issuer or publisher, provided the reissuing member or member organization is not required to pay for such consent.

(Exception: This policy does not prohibit the furnishing by a member or member organization to a non-member professional (i.e., broker-dealer in securities or commodities, insurance company, investment adviser, investment manager, bank, trust company, foundation, professional trustee, or one engaged in any closely allied activity), of publications of nominal cost, i.e., aggregating not more than approximately $30 per year, per non-member professional.)

(2) To another member or member organization or to a non-member customer who is a non-professional, statistical or investment advisory services

(A) prepared by the member or member organization, or

(B) prepared by others and reissued by the member or member organization.

The meaning of "statistical and investment advisory services" above is restricted to publications or services intended to aid professional or non-professional clients of member organizations in investment decisions concerning securities or commodities. All such publications or services must be clearly and prominently identified as being a publication or service of the original issuing member organization. (The name of the original issuing member organization may be omitted if the distributing member organization clears its listed business through the issuing member organization.)

.11 *Fees.*—Such service which is prepared or reissued by the member or member organization consistent with .10 above, may be furnished by the member or member organization to another member or member organization or to a non-member, either free of cost or on a fee basis. If such service is furnished on a fee basis, the fee may be adjusted in accordance with commission business received from the other member or member organization or from the non-member.

The fee for investment advisory service may be based on a percentage of the principal amount of the funds involved but may not be based upon the profits realized.

Different fees may be charged to different customers for the same or equivalent statistical service.

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